REPORT ON
CANADA MORTGAGE AND HOUSING CORPORATION

October, 1979

Published under the authority of the
Minister Responsible for CMHC

October 26, 1979

The Honourable Elmer MacKay, P.C., M.P.
Minister of Regional Economic Expansion
Minister Responsible for Canada Mortgage
and Housing Corporation
Room 458, Confederation Building
House of Commons
Ottawa, Ontario
K1A 0A6

Dear Mr. MacKay:

It is with great respect that we submit the Report on Canada Mortgage and Housing Corporation.

The report was produced by a Research Staff and Secretariat, with the advice and assistance of the Task Force and the Chairman's Advisory Committee, which were organized for the express purpose of reporting on:

(i) the current position of CMHC;

(ii) the projected housing needs of the 1980's;

(iii) the organization that will best deal with the current circumstances and serve the shelter needs of all Canadians in the 1980's.

We purposefully avoided any attempt to allocate responsibility for possible past short-comings. We have identified the current situation and proposed a course of action that will rationally deal with the immediate concerns and allow the Government of Canada to respond to the housing needs of Canadians in the 1980's.

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During the course of the study, we received submissions from a broad spectrum of interested Canadians and met with every group that specifically requested a meeting. Everyone concerned was honoured to have the opportunity to serve the Government of Canada in the preparation of this report.

Sincerely,

Donald J. Matthews
Chairman

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REPORT ON CANADA MORTGAGE AND HOUSING CORPORATION

Note: Ce rapport est aussi publié en français.

1 INTRODUCTION

Canada Mortgage and Housing Corporation (CMHC) has traditionally acted in the housing market to affect the rate of housing production and the distribution of housing units both between income groups and geographic locations. The Corporation's activities have changed over its 34 years of existence in response to increasing activity by the private sector and provincial governments in the financing and in the initiation and operation of housing for modest and low income households.

A reassessment of CMHC's activities in the provision of housing to Canadians is prompted by the following concerns of the new government: first, an examination of duplication of federal and provincial government services is expected to result in clarification of federal and provincial jurisdictional responsibilities; second, the federal government has announced measures for a mortgage interest and property tax credit and is considering capital cost allowance provisions for rental units which will have an important effect on housing markets; third, the federal policy of expenditure restraint make this an opportune time to emphasize those activities of CMHC which could be operated without hidden or open subsidies; fourth, and most important, the federal government has announced its intention to withdraw from activities more appropriately carried out by the private sector. This study is the direct result of that concern.

Accordingly, the government appointed a Task Force under the Chairmanship of Mr. Donald J. Matthews to prepare this report. The Task Force was composed of representatives of the Department of Finance, Treasury Board Secretariat, the Department of Justice, the Privy Council Office, the Department of Energy, Mines and Resources, and Canada Mortgage and Housing Corporation. The Task Force was expertly assisted by an Advisory Committee composed of representatives of the building trades, private financial institutions, and the

academic community. The Task Force also consulted extensively with all sectors concerned with housing and greatly appreciates the time and effort taken by these groups to express their views.

The views expressed in this report were thoroughly discussed by all concerned and represent a unanimous concensus of the Advisory Committee. This document, while being published under the authority of the Government of Canada, is not a statement of government policy, nor should it be assumed that the government agrees with all aspects of the analysis contained in the report.

1.1 Terms of Reference

Cabinet has directed that the Task Force study the potential for privatizing at least certain of the activities (as opposed to privatization of the corporation as a going concern), or encouraging the private sector to take a larger role in certain of the activities of CMHC. The Task Force report would focus on:

(i) The policy implications of privatization in each case;

(ii) The legal and financial implications of privatization;

(iii) Alternate modes of privatization in each case with a discussion of a preferred modality;

(iv) A proposed strategy and timetable for privatization.

With these terms of reference in mind, the Task Force has tried to look at all aspects of the Canadian housing scene as it has developed over the last sixty years. We have looked at the details of that evolution and we have also tried to view it from a broader perspective. It is only when the pattern becomes visible that we can properly assess not only what the federal government has done in the past, but also, and

above all, what is future place should be in the housing field.

The objective of this report is to make that assessment, not in terms of any absolute dogma, even that of privatization, but rather in terms of a realistic appreciation of the future housing needs of Canadians in all regions of the country and the most effective ways in which those needs can be met in a free and pluralistic society such as ours. We do not reject at the outset any role for the federal government in meeting those needs; but neither do we assume that it must automatically and in all circumstances play the leading role and bear the major share of the responsibility for meeting housing needs.

We have tried, in this report, to consider objectively the areas in which government activity remains necessary and desirable, as well as those in which the private sector may be able to do the job better. And, while we argue for a change in the balance between the public and private sectors in the housing field, we respect and wish to maintain the tradition of co-operation that has long existed between public and private enterprise in this area of activity. The federal government in general, and Canada Mortgage and Housing Corporation in particular, have a long and honourable history of involvement in housing and mortgage markets, and we have no intention of suggesting that this should be otherwise in the future.

1.2 Overview of the Report

Chapters 2 and 3 of this report establish the context for an analysis of the activities of CMHC on the program front: Chapter 2 begins with a review of the evolution of the federal and provincial roles in housing markets since the first federal housing legislation and concludes with a detailed statement of the rationale for government intervention in housing markets; Chapter 3 describes the evolution of housing conditions in Canada since the Second World War, and

shows the more important factors which will affect housing markets in the 1980's.

Chapter 4 gives a detailed description of the major programs operated by CMHC since 1945, as well as a statement of other programs or provisions of the federal government which have an impact on housing markets. Chapter 4 clearly illustrates the dual role that CMHC has played on behalf of the government: the Corporation operates in a financial capacity in its lending and mortgage loan insurance functions and in a departmental capacity in administering housing subsidies on behalf of the government. These two capacities are integrated in the design of most programs of CMHC.

The mix of activities carried on by the Corporation and a number of other factors, including the legislative environment in which the Corporation operates, have resulted in a number of financial difficulties which are now cause for serious concern. The financial aspects of CMHC's operations are described and analyzed in Chapter 5.

Chapter 6 first summarizes the implications of continuing with the status quo, and then presents a number of realistic options to be considered in the review of the activities of CMHC.

The report concludes in Chapter 7 with recommended changes in CMHC's financial and departmental functions, an assessment of the financial implications on the federal government if the recommendations were implemented, and a discussion of considerations raised in the area of federal-provincial relations.

This Chapter describes the evolving federal and provincial roles and provides a detailed statement of the rationale for government intervention in housing markets.

2.1 Evolution of Federal and Provincial Roles in Housing Markets

The federal government first entered into housing policy in 1919 when it provided $25 million in loans to the provinces which in turn were lent to municipalities for the construction of modest quality housing. More than 6,000 units were constructed under this program before it was terminated in 1923. The rationale behind the program was not to provide housing for any particular group but rather to relieve what was thought to be a general scarcity of housing for Canadians.

During the 1920's there was a construction boom in Canada and it was not until the Depression that the federal government entered into housing policy on a permanent basis. The Dominion Housing Act of 1935 established a federal loan fund of $10 million for prospective builders and owners. Under this program, the federal government made loans jointly, on a 25-75 per cent basis, with authorized private lending institutions; provided an interest subsidy and capital guarantee which virtually eliminated all risk of capital and interest loss on funds advanced by institutions; and had the right to set lending terms and conditions under which funds would be advanced. The major objective of this policy was to stimulate the economy.

The year 1938 saw the introduction of the National Housing Act with the following objectives stated by the federal Minister of Finance:

(i) a substantial contribution to the elimination of unemployment in the field where it has been most

heavily concentrated, and to the general stimulation of business recovery; and

(ii) a substantial contribution to the improvement of housing conditions particularly for families with low incomes.

There were three parts to the Act. Part one made possible 90 per cent loans on houses costing less than $2,500 and guaranteed loans of $4,000 or less in remote areas. Part two allowed limited dividend companies or municipalities to borrow funds at subsidized rates from the federal government to provide low income rental projects. Part three authorized the federal Minister of Finance to pay all municipal taxes for one year on houses costing less than $4,000, and 50 and 25 per cent in the following two years if the municipality provided building lots for $50. Part one was used extensively with over 15,000 loans authorized over four years. Part two lapsed in 1940 with only five provinces passing enabling legislation, while part three lapsed in 1940 after having been little used.

By 1944 there was grave concern that demobilization would be followed by a massive housing shortage as well as widespread unemployment. The National Housing Act (NHA) of 1944 was introduced to help deal with these problems. It was basically a consolidation of its predecessors and maintained the technique of joint loans, loan guarantees, and loans to limited dividend companies. The main features of this program remained intact until 1954. Two changes that did occur in the pre-1954 period, however, were the establishment of CMHC in 1945 to administer the National Housing Act and the passage of legislation in 1949 in which the federal government offered 75 per cent of the capital and operating costs of public housing projects to provinces undertaking their construction and operation.

Even though there was legislation focussing on the objective of housing redistribution (i.e., limited dividend and public housing legislation), the emphasis was on increasing the production of housing in the pre-1954 period. By creating a virtually risk free

investment in mortgages and setting the charge for absorbing these risks below what lenders would normally incorporate in their calculation for making an uninsured loan, the loan guarantee and insurance program enhanced the long run desirability of residential mortgage investments. Thus, government policy clearly sought to increase the efficiency of the private sector and to work with it to stimulate residential construction and upgrade housing standards.

Although stimulating housing demand remained a long run objective of federal policy, the emphasis shifted after 1954. The most prominent innovation of the 1954 National Housing Act was the replacement of the joint lending technique with the present system of mortgage insurance, although the government still reserved the right to set the interest rate on NHA mortgages. Provision was also made for the establishment of a secondary market in NHA mortgages; and the chartered banks, which had been previously excluded from the market, were empowered to initiate NHA loans. The primary objective of these changes was to increase the availability of mortgage funds from the private sector. Thus, government policy still sought to encourage private sector lending rather than replace it with direct government lending.

The gains in obtaining additional sources of funds from the private sector were short-lived, however. Funds for mortages were being squeezed by the demands for funds for other purposes. The NHA interest rate, administratively set by the federal government at this time, was increased in an attempt to obtain greater private financing. However, a continued upward movement in all interest rates quickly eroded any gains: the government was faced with the prospect of further increasing the interest rate on NHA loans, which would have precluded the chartered banks from participating, given their interest rate ceilings imposed by the Bank Act. It was therefore decided to increase funds for residential mortgages through CMHC direct lending.

The government philosophy behind this policy appeared to be one of assisting, rather than replacing, the private sector. CMHC direct lending was supposedly residual in the sense that borrowers had to demonstrate, via rejected loan applications, that they were unable to obtain private financing on NHA terms. Although this offset some private sector lending, it has been shown that 75 to 80 per cent of this lending was residual in the sense that it provided a net addition to the supply of mortgage credit. Thus, the government not only prevented the decline of private mortgage funds, resulting from market imperfections, from causing a significant reduction in construction activity, but also used housing as a major force for stimulating the whole economy during the years 1957, 1958, and 1959.

Finally, in 1961, the federal government through CMHC began to provide loans to municipalities for the provision of sewage treatment plants and trunk sewers. This program also stimulated residential construction by increasing the availability of serviced land.

Although provinces had undertaken some joint investment with the federal government for public housing, with the exception of Nova Scotia, provincial governments did not make great use of the National Housing Act, until 1964. A major revision of the Act in that year authorized the Corporation to provide direct loans to the province for 90 per cent of the capital cost of public housing projects and to share the operating loss on a 50-50 basis; to make a 90 per cent loan for land acquisition and servicing for the project; to loan to non-profit corporations owned by a province or municipality for low rental projects; and to permit greater funding of urban renewal programs for a wider range of projects.

These amendments had three effects. First, they resulted in a decentralization of housing policy, with provincial housing corporations beginning to assume increased responsibility. Second, the amendments shifted the focus of CMHC from one of market efficiency concerns to one of redistribution. Third, CMHC in

conjunction with the provinces began to undertake programs such as land assembly which before had been undertaken by the private sector.

By the late 1960's, the provinces were significant actors in the housing field. Several provinces were operating home ownership incentive programs and a dwelling unit rehabilitation program was successfully operating in Quebec. By the late sixties, the changes in the objectives of federal and provincial housing policy were increasingly evident. For example, between 1949 to 1967, a nineteen year period, approximately $172 million was committed for public housing. In comparison, in the two years 1968 and 1969, over $377 million was committed to public housing.

Indeed, by 1967, the federal government was faced with a difficult choice. Either it could withdraw substantially from the provision of direct loans to finance large volumes of 'private market housing'; ignore the provincial demands for funds to finance social housing; or substantially increase its financial commitment to housing. The federal government chose to support provincial priorities but also undertook three policy initiatives in the late 1960's to further remove imperfections in the mortgage market and thus increase the supply of private funds available to the construction industry.

First, the government relinquished its authority over the maximum rate of interest that qualified for NHA insurance, thereby allowing the NHA mortgage rate to be set by market conditions. Second, the minimum term on an NHA loan was reduced from 25 to 5 years which allowed deposit-taking institutions to match the maturity term of their liabilities with their NHA mortgage investments. As a result, NHA mortgages become a more attractive investment. Finally, revisions of the Bank Act in 1967 allowed the chartered banks to make conventional loans and simultaneously removed the six per cent ceiling on bank loans. This led chartered banks to re-enter the mortgage market which they had left in the late 1950's.

In the field of housing, the early 1970's could be characterized as a period of federal-provincial joint programming for income support purposes. In 1973, the federal government introduced measures which made some of the principles contained in individual provincial programs available to all Canadians. The federal government encouraged provincial governments to integrate federal and provincial programs rather than operate parallel programs, and for a short period of time, federal and provincial housing policy operated in remarkable harmony. Together, the federal and provincial governments implemented programs for public housing; improved non-profit and co-operative projects; established programs to respond to the unique housing needs of rural and native persons; and provided assistance for community revitalization.

Federal objectives at this time included stimulation of residential construction for cyclical stabilization purposes, assistance to middle income groups which were experiencing difficulty in buying homes because of inflation, improvement of the community environment in which the housing units were placed, and subsidization of rental production for households whose incomes were not tested. The overall policy became one of bridging the inflationary gap with public funds. By 1975, pressures on federal loan funds became too great and a policy shift was made from federal financing to the provision of federal subsidies on privately financed housing. For example, CMHC direct loan commitments under the Assisted Home Ownership Program were $458 million in 1975, decreasing to $80 million in 1976, and less than $2 million by 1978.

At this time, the federal government also began to withdraw from joint federal-provincial efforts and provincial priorities were reassessed. The result was a proliferation of new programs with a wide range of objectives and functions, based on provincial government priorities. Provinces also withdrew from federal-provincial public housing as the staggering costs and massive inequity of the program toward individuals became evident.

In the last two years, the policy objectives of CMHC have focussed on the provision of housing for low income groups and providing assistance to municipalities for community services. However, the financial intermediary role of CMHC has been greatly diminished. With respect to the low income housing programs, CMHC provides annual assistance to provinces or others undertaking projects, but has greatly curtailed loan commitments to these groups. As for the provision of community services, the massive loan commitments made for municipal infrastructure and neighborhood improvement have been withdrawn and replaced by a system of grants. In all cases, borrowers are expected to obtain funds from private lenders rather than from CMHC, although CMHC retains a much reduced residual lending role to ensure that funds are made available in smaller communities where private lenders are not active.

Provincial programs remain varied across the country and relate to the specific market conditions in each province. Common concerns, however, are housing rehabilitation, energy conservation, and limitation of government financial intermediary roles, with the last concern resulting mainly from budget constraints rather than an explicit housing policy. There is considerable interest in direct assistance to the individual, to ensure flexibility in choice of accommodation and market place adjustment to demand for good quality accommodation.

It is clear from this brief historical description that the emphasis of CMHC and provincial agency activity has evolved continuously over the past 40 years. Throughout this period, housing has been used, when thought necessary, as an economic stimulation tool. However, the thrust of federal and provincial policies has shifted considerably, beginning with the emphasis in the thirties and forties on employment and demand stimulation, shifting in the fifties to a concern with the availability of housing finance, and in the late sixties and most of the seventies to a preoccupation with social policy and income redistribution. Finally,

in the late seventies we have witnessed a reduction in government assistance and direct market intervention.

During this whole period, policy emphasis has also shifted, primarily from one of assistance to the private sector through the removal of market imperfections which impeded the free flow of funds and resources into housing, to one of competition with the private sector through financing public and non-profit housing. Just as housing policy has responded to changes in market needs and the economic and social environment in the past, it is now appropriate to reconsider the focus and emphasis of government activities, as current housing conditions and emerging trends for the 1980's are vastly different from those of the past. Budget constraints on both federal and provincial governments will be a constant factor in the development of any government housing program in the foreseeable future, but there is also a new dimension to federal-provincial housing programs involving the clarification of roles and responsibilities between the federal and provincial governments. Housing conditions and trends are described in Chapter 3 of this report.

2.2 Rationale for Government Intervention

This section reviews the traditional economic rationale for government intervention in housing markets, and considers in a broad way the relevance of this rationale for Canada. The initial parts of each of the subsections are concerned primarily with the rationale for government intervention *per se*, without considering whether federal or provincial jurisdiction would be more appropriate for this intervention. The jurisdictional issues and the transmission mechanisms are then considered at the end of each subsection.

In a market economy, the primary reasons for government intervention in the housing sector are:

(i) to compensate for market imperfections in the allocation of capital and resources to the housing sector;

(ii) to compensate for externalities in the production or consumption of housing services;

(iii) to redistribute income; and

(iv) to reduce cyclical fluctuations in residential construction.

Market Imperfections

(i) Market Imperfections in the Allocation of Credit

When capital markets operate perfectly, capital is allocated according to the relative strengths of competing borrowers. In such a situation, funds would be made available by the market so that all the effective demand for housing services would be satisfied, since unsatisfied demand for more housing would be reflected in an increased demand for mortgage credit and hence in a higher mortgage rate. Lenders would find mortgage investments relatively more attractive than previously and increased funds would be allocated to the housing sector until the excess demand was satisfied. However, when market imperfections exist, the mechanism is broken, leaving some housing demands unsatisfied and resulting in a less than optimal supply of housing. The implications of such imperfections in the mortgage market are considerable because capital expenditures in the housing market are usually financed with a very high proportion of mortgage debt compared to owner equity, and variations in the rate of interest and in the supply of mortgage funds exert a substantial effect on housing demand and new residential construction.

It has been claimed that mortgage borrowers occupy a residual or secondary position in financial markets because of their relatively high sensitivity to interest costs and because of the nature of the mortgage instrument. The high interest sensitivity does not constitute a legitimate market imperfection because it merely reflects the relative preferences of

mortgage borrowers. In contrast, the second reason -- undesirable investment characteristics of the mortgage instrument -- can be classified as a market imperfection.

Until recently, the mortgage instrument had a number of features that made it a relatively unattractive vehicle for institutional investment. Among the undesirable characteristics were the non-liquid nature of mortgage investment, resulting from the lack of an efficient secondary market and the long term nature of the investment; the relatively high risks arising from the local nature of the investment; the asymmetry in interest risk arising from borrower repayment privileges; and the relatively high selection and administrative costs associated with mortgage lending. Consequently, financial institutions required a considerable yield premium to undertake the risks and costs of mortgage lending and tended to increase their participation in the market only when demand in other sectors lagged.

However, one of the major successes of federal housing policy and private sector response has been the elimination of the residual aspect of mortgage investment by financial institutions. This change came slowly and in stages but was directly facilitated by the federal loan insurance program which reduced the default risk for lenders and widened their mortgage participation. Once their scale of operations increased, the liquidity of their mortgage portfolios increased and selection and administrative costs declined. The eligibility of 5 year term mortgages for insurance and the financial industry move to periodic interest rate adjustments ended the asymmetry in interest risk and further increased the liquidity of mortgage portfolios. Together with the removal of the yield ceiling on government insured loans, this eliminated most market rigidities. Consequently, mortgage investments should no longer be considered a residual outlet for investment in Canada.

Reinforcing these conclusions is the virtual elimination in recent years of lagged and incomplete

mortgage rate adjustments in Canada. In the past, mortgage rates adjusted more slowly and moved within narrower limits than rates of interest on other securities, which reduced the attractiveness of mortgage investments during periods of rising interest rates. The freeing of the NHA mortgage rate, the elimination of restrictions on mortgage lending, and the absence of regulations on interest rates paid by financial institutions permit fast and more complete market adjustments, which allows us to say that the long term flow of funds into mortgages is presently not obstructed in Canada.

On the other hand, the mortgage market and its problems are constantly evolving and the market is not completely perfect. One relatively new imperfection is the disproportionate impact of inflation on housing demand. During inflationary periods, expectations of future inflation are incorporated into economic decisions and are reflected in the level of interest rates. When existing inflation creates inflationary expectations, the mortgage rate rises, such that a 5 per cent increase in the expected rate of inflation increases the mortgage rate by approximately 5 percentage points, for example, from 9 per cent to 14 per cent. This substantially increases the proportion of income which a household must devote currently to housing, thus reducing housing demand and the flow of resources into housing. The concomitant decline in housing demand and flow of funds into housing arises not from a decline in the desire to purchase housing, but from a market imperfection which disproportionately increases the real costs of homeownership when the expected rate of inflation rises. This is the so-called 'tilt' problem.

A variety of proposals such as the variable rate mortgage and price level adjustment mortgage have been made to offset this imperfection, but they have not been widely accepted in the private sector. Consequently, some contingency role may still remain for federal housing policy to offset market imperfections, and to encourage the private sector to eliminate any imperfections.

The primary government mechanism for reducing capital market imperfections has so far been to increase the relative attractiveness of the mortgage instrument for private financial institutions, and when this approach was insufficient, to provide funds directly.

Any development that improves the investment characteristics of the mortgage instrument, compared to alternative investments, increases the flow of funds into mortgages. Changes in the characteristics of the mortgage instrument can take many forms, ranging from the introduction and broadening of federal guarantees or insurance, to the creation and improvement of a secondary market in mortgages. These changes reduce the risks associated with mortgage investment and encourage institutions to devote a higher proportion of their funds to mortgage investments. Federal programs that alter the investments characteristics of mortgages include the federal loan insurance program and CMHC auctions to develop a secondary market in NHA mortgages.

There is little doubt that the federal loan insurance program has greatly increased the long run attractiveness of mortgage investments for financial institutions, and increased the total long term flow of funds into mortgages.

However, the program now generates a relatively small net increase in mortgage availability. This is, in part, a result of its success in reducing impediments to the flow of funds into mortgages and, in part, a result of the evolution of the capital markets and development of private mortgage insurance. Since the program involves no transfer of federal funds, the insurance role could be viable for the private sector.

However, given the contribution this form of program has made and the uncertainty as to the nature of future impediments in the mortgage market (such as the disproportionate impact of inflation discussed earlier), it may be appropriate for the federal government to retain contingency insurance powers in this area.

Consideration should also be given to the market structure implications of federal withdrawal. Would such withdrawal, for example, lead to monopoly or collusion among private insurers? With proper supervision by the Superintendent of Insurance and staged privitization this problem can probably be avoided, but it requires careful consideration in advance.

(ii) Market Imperfections in Real Resource Allocation

A second set of market imperfections can arise on the real resource side. It has been claimed, for example, that market imperfections exist in residential land and labour markets in the form of oligopoly or monopoly power exercised by labour unions and land development companies.

However, previous studies suggest that there is little evidence to support these claims. With respect to residential construction labour, the Economic Council of Canada has reported that apart from the Province of Quebec where union membership is compulsory, only five to ten per cent of residential construction labour is unionized and that construction workers are generally quite mobile geographically. With respect to residential land, in 1978 the Federal/Provincial Task Force on the Supply and Price of Serviced Land concluded that there was no evidence to support the monopoly developer theory which asserts that ownership of undeveloped land is concentrated in the hands of a small number of powerful developers. Consequently, the need for direct government intervention appears low, although there may be a role for government to use legislation to ensure that monopoly power does not arise in the future.

On the other hand, market imperfections in land markets often arise because of government planning regulations and zoning restrictions. Such regulations and restrictions arise naturally because municipal revenues and most municipal costs are related to property and its uses, and municipalities are therefore reluctant to accept development below a break-even level of

assessment. The problem is exacerbated by taxpayer resistance to new development due to the fact that the costs of major services such as trunk sewers and roads are borne by all existing residents on behalf of future residents. Even if these services are financed by the use of debt, a burden is still imposed on existing residents. Finally, residents are also concerned with maintaining the quality of their neighborhood and the quality of the environment, which reinforces the desire for municipal regulation.

Government has a variety of mechanisms at its disposal to combat monopoly and municipal land servicing problems. With respect to monopolies, if they exist, the appropriate vehicle may be anti-combines legislation rather than direct market intervention via the creation or funding of public land banks. With respect to land servicing problems and municipal resistance to new development this is constitutionally a provincial matter. The role of the federal government could be reduced to providing assistance to provinces for funding services if a case could be made that there was an extra-provincial benefit from such expenditures.

(iii) Discrimination in Housing and Mortgage Markets

Imperfections in both the housing and mortgage markets could arise because of discrimination against certain groups. As an example, in the housing market, some landlords may refuse to rent units to students or single parent families. Similarly, in the mortgage market, discrimination may exist against some borrowers such as women or native people and against some properties located in areas, such as rural areas or rundown neighborhoods, which lenders feel are undesirable. To the extent that discrimination does exist, government efforts should be directed toward removing the source of the problem.

(iv) Problems with Second Best

In addition to the possibility of private sector market imperfections, there is the possibility of government-created imperfections in the housing market. For

example, distortions are created by rent control and the pricing of energy at less than replacement cost. Rent control substantially distorts the rental housing market by reducing the supply and quality of the rental housing stock. Policies such as rent control are often introduced to remove or redress existing distortions, but often create new and more severe ones. To the extent this is true, as in the case of rent control, the best solution for reducing market imperfections stemming from a government policy is clearly to eliminate the policy in question. If the elimination of these policies is not feasible for institutional, political, or other reasons, as a second best solution, the government might provide subsidies which produce an incentive to minimize the distorting impact of the policies. For example, subsidies for rental construction would reduce the distortions created by rent controls.

In order to prevent one level of government from introducing a policy for its own strategic advantage and looking for another level of government to bail it out from undesirable effects of the policy, each level of government should normally be responsible for programs used to offset its self-generated distortions. This suggests that it would be inappropriate for the federal government to provide funds to stimulate rental construction solely in response to provincial rent control programs. On the other hand, it might be appropriate for the federal government to provide temporary assistance to the provinces in the transition stage as they phase out market-distorting programs.

Externalities

When a commodity provides positive or negative benefits not only to those directly consuming it but also to all or a part of society, that commodity is said to be generating positive or negative externalities for society. Since individuals will only pay for the benefits they receive directly, and not for the benefits that accrue to all society, these external benefits are not reflected in the price. The price of

these commodities thus reflects only the private benefit, which leads to an undersupply of commodities with positive external benefits and an oversupply of commodities with negative external benefits. If such externalities exist for housing, there is a role for government to encourage the adjustment of production to compensate for these externalities.

(i) Neighbourhood Externalities

The value of a dwelling unit and the services which it provides are related to both the structural characteristics of the dwelling unit and to the characteristics of the neighbourhood in which the unit is located. The existence of neighbourhood externalities for housing can be seen from the following examples.

First, many types of land use such as sanitation landfill or pollution intensive industry are incompatible with residential land use. If these operations move into a residential neighbourhood, the value of the dwellings in the area will decrease and the level of new construction will be lower than the other characterisitics of the area might warrant. Government intervention in the form of zoning regulations could be used to prevent the introduction of land uses with negative externalities, although, as discussed earlier, the inappropriate application of these by-laws could introduce a different problem, namely market imperfections.

Second, a 'prisoners dilemma' situation may arise in which an owner may refrain from adequately maintaining or improving his property because he feels this will not enhance his property unless others in the neighbourhood follow suit. If all area residents take this attitude, under maintenance of properties will occur, and consequently government intervention through a maintenance subsidy, or minimum standard regulation, may be required to reach the appropriate level of maintenance. Because neighbourhood externalities are likely to be local in nature, local governments are usually the appropriate level of government to deal with them.

(ii) Housing Quality Externalities

It is often claimed that external benefits accrue to society from better housing in the form of a reduction in crime and infectious disease, a reduction in the alienation of the population, encouragement of better child up-bringing, and psychic benefits from the elimination of visible slums. Evidence that good housing results in these external benefits except in the case of most extreme housing deprivation is, however, lacking, although it is possible that some social benefits might be experienced only by later generations and thus be very difficult to measure.

As discussed above, to the extent that such positive externalities exist, too little housing is being consumed because the private benefits are less than the social benefits. This problem is amenable to government action to stimulate demand by such policies as interest rate subsidies or grants to homeowners and rental subsidies. Because these policies reduce private costs below social costs, they compensate for the shortfall in private benefits below social benefits. A strong case could be made for federal government intervention if such externalities are global rather than local in nature. As well, it is important for minimum housing standards to be approximately uniform across the nation to avoid effects on internal migration and the allocation of resources.

(iii) Information and Innovation

The purchase or rental of a dwelling unit involves the purchase of many complex components such as foundation, electrical wiring, and plumbing. Since it is unlikely that each consumer will be well-informed as to claims about the quality of each of the components, there is a legitimate role for government to provide information regarding these materials or to use standards and require inspections to ensure the quality of dwelling units. This role is already played by a variety of government agencies, such as Corporate and Consumer Affairs, and is handled by way of a National Building Code.

With respect to innovation, builders and lenders may underinvest in research into innovative techniques such as alternative building technologies or lending techniques since innovations can easily be copied by competing firms at relatively low cost. Thus, while the industry on a collective basis may have a desire to obtain new technologies, the individual firm may have a reduced incentive to invest in research projects.

Housing and Redistribution

In virtually every western country, housing policy has been consciously used to meet the objective of redistribution toward households with low incomes. Traditional economic theory, however, suggests that unconditional cash transfers are more efficient and appropriate than in-kind transfers in making goods and services more generally available to various members of society. This is based on the principle of consumer sovereignty. With cash transfers, the recipient can utilize the transfer to purchase goods and services according to personal preferences. With housing transfers, on the other hand, the recipient must use the money to purchase housing, which in turn means that the recipient must receive a larger housing transfer to reach a given level of satisfaction. As a result, the cost of housing subsidies overstates the benefits to direct recipients. We would therefore argue that in-kind transfers should have social benefits such as those discussed in the previous section if they are to be used for improving consumer welfare and income distribution.

Reinforcing the economic argument against income redistributive housing subsidies instead of direct cash payments are the effects on non-recipients. Since housing subsidies increase the amount of housing services demanded by the recipients more than the equivalent cash transfer, they increase the total demand for housing. This increases the cost of housing for non-recipients of the subsidies and also shifts resources disproportionately into the housing sector.

On the other hand, there are persuasive political and social arguments for in-kind transfers. First, society may not be interested in income equality so much as in equal access to certain basic goods and services, such as medical care, education, housing, and the environment. If this is the case, policies that transfer medical services, education services, and housing are politically more acceptable and likely less expensive than income transfers.

Second, government may want to impose minimum standards on all housing and the environment to avoid problems such as the 'prisoners dilemma' in maintenance. In so doing, the government may force certain low income households to spend a relatively large portion of their income on housing and may wish to do this by direct housing subsidies.

Third, it is sometimes felt that those households requiring assistance cannot effectively handle their own resources. Related to this is the notion that housing transfers benefit the total household receiving the transfer because all members have access to the dwelling unit. Income transfers, on the other hand, go to individuals, and may not benefit the whole family unit. Many current housing redistribution policies appear to reflect this paternalistic concern, in that eligibility requirements are generally limited to either elderly households or family households with children.

Finally, adequate and suitable housing pertains not only to the structure but also to the type of neighbourhood in which it is situated, the accessibility to various public facilities, and the nature of the environment as indicated by adjacent land uses. Evidence suggests that lower income households tend to cluster together in the central municipality of an urban area, primarily in inner city neighbourhoods, and that these clusters are characterized by lower quality housing stock and level of community services. If this were felt to warrant government intervention, policies could be designed to focus on both the individual and the neighbourhood, with the higher

levels of government providing community service subsidies or grants to those municipalities which have a relatively high concentration of low income households.

The answer to the question of whether housing redistribution is appropriate therefore depends on the objectives specified. If the objective is one of general income redistribution, cash transfers are more appropriate. If, however, the objective is one of ensuring that households have adequate housing at an affordable price, housing related transfers may be more appropriate.

The primary direct mechanisms for housing redistribution have been through the use of CMHC as a financial intermediary and departmental agency providing subsidies, and through demand stimulation policy. In its financial intermediary capacity, CMHC obtains funds by issuing debentures purchased by the federal government.

Although CMHC housing loans and subsidies are substantial, the net increase in real resources devoted to housing is considerably less than the allocation of public funds. This occurs because of capital market offsets, reduced non-subsidized real demand, and higher prices and costs.

At the present time, the redistribution aspect of housing policy is conducted jointly by the federal and provincial governments in Canada, with provinces initiating activity and the federal government providing assistance in the form of grants or loans at below market interest rates through CMHC. Federal government involvement occurs for a number of reasons. First, the federal government is in the best position to equalize the fiscal capacities of lower levels of government. This is important because it is likely that provinces which can least afford a redistribution housing policy are the same provinces which have a disproportionate share of households requiring assistance. Second, the federal government is best able to ensure that differences in redistributive policy among provinces do not lead to artificially

induced inter-provincial mobility or to gross inequities between individuals in similar circumstances in different provinces.

On the other hand, it is essential to recognize the local or regional governmental role since housing market conditions vary greatly across the country and different approaches to housing redistribution may thus be appropriate for different parts of the country. This in turn may require considerable diversity within federal programs, if the government wishes to play a leading role in providing in-kind housing transfers.

Cyclical Fluctuations in Residential Construction

Residential construction is one of the most volatile sectors in the economy. This volatility is often increased substantially by the disproportionate impact of monetary policy. Residential construction displays a countercyclical pattern in which housing starts increase during periods of sluggish or declining economic activity, and decrease during periods of marked economic expansion. The explanation for this hinges on the behaviour of the capital market and the sensitivity of the demand for housing in relation to price.

When economic activity expands, the demand for loanable funds exerts upward pressure on interest rates. This adversely affects the availability of private funds for housing because the mortgage - bond yield differential will decline as a result of the increased non-housing demand for funds and this induces financial institutions to reduce the proportion of their new investments flowing into housing. Reinforcing this reduction is a general slowdown in the flow of funds into financial institutions as primary security yields rise. At the same time as mortgage availability declines, the rising mortgage rate reduces the demand for new housing since the demand for housing is more sensitive to interest rates than demand in other investment sectors. The anti-cyclical monetary forces usually outweigh the pro-cyclical income forces causing

residential construction to fluctuate in an anti-cyclical manner.

These fluctuations are generally reinforced by monetary policy which usually becomes restrictive in the sense that monetary demand accelerates more quickly than the money supply during economic expansions. These restrictions increase upward pressure on interest rates and generate a sharper and more prolonged contraction in residential construction activity. Moreover, monetary policy exerts a disproportionate impact on residential construction because of the high sensitivity of both demand and supply of funds in this sector to changes in the interest rate.

From a macroeconomic point of view, this behaviour is quite desirable because residential construction automatically stabilizes economic fluctuations and provides the vehicle by which monetary policy is transmitted to the rest of the economy. The faster and stronger the response of this sector to monetary policy, the more efficient monetary policy will be in general economic stabilization. From a sectoral point of view, however, the disproportionate impact of monetary policy on residential construction raises the question whether one sector should bear the brunt of general economic stabilization.

The issue is far from decided. Most market economists support the proposition that if this volatility arises from the high interest sensitivity of demand and not from specific market imperfections or rigidities, there is little reason to interfere. Most housing economists, on the other hand, argue that boom and bust cycles increase housing costs, bankruptcies, and inefficiencies, and consequently lead to under-capitalization in residential construction and prejudice long run resource allocation against housing. However, unless a housing contraction is extremely severe, long run resource allocation is unlikely to be significantly affected by the extra volatility because factors of production flow relatively freely between residential and other forms of construction and because housing demand curtailed during an economic expansion

is not permanently lost but only postponed until the next phase of the cycle.

Acceptance of this position leads to the conclusion that policies to reduce cyclical instability in residential construction should be aimed at removing market imperfections which impede the smooth flow of funds into housing and at offsetting severe contractions in residential construction when general stabilization requirements dictate extremely tight or prolonged monetary restriction. Government programs to dampen fluctuations in residential construction are warranted only to compensate for insufficiencies in the availability of funds for housing arising from short term (6 to 9 months), incomplete interest rate adjustments, and to prevent excessive contractions in residential construction arising from an extraordinarily severe application of monetary policy for general macroeconomic purposes, such as support of the dollar on the international scene. The use of housing programs in this manner would not conflict with macro-stabilization and may enhance it, by allowing monetary policy to be more stringent than would otherwise be possible because of its disproportionate impact on the housing sector.

The federal government has a variety of tools to influence the timing of residential construction activity, ranging from monetary and fiscal policy to selective credit and direct expenditure policies. Since monetary and fiscal policy are usually conducted for general stabilization purposes and not specific sectoral purposes, the primary cyclical tools are selective credit programs via changes in the terms which qualify for federal loan insurance and direct loans and subsidies from CMHC.

Variations in NHA lending terms such as the loan-to-value ratio, the amortization period, the proportion of monthly carrying costs to income that qualify, the method of measuring family income, and the maximum loan size can theoretically be used to affect housing demand. However, the fact that most of these terms can be more readily eased than contracted, means

that lending terms are unlikely to be varied in the symmetrical way necessary for a proper stabilization tool. Moreover, successive easing of these terms reduces their future stimulative potential which eventually eliminates them as tools.

CMHC direct lending can be used more readily, since this does not require adjustments within private financial institution portfolios, and all the terms, including the interest rate, can be varied to influence demand. Of course, if direct lending is to perform this role, its function should be to mitigate major swings in residential construction resulting primarily from monetary policy. By sheltering housing from the full brunt of monetary policy, direct loans enable monetary policy to be pursued more vigorously and to have its effects spread accross the economy. CMHC or another agency could also be used to conduct mortgage banking activities, purchasing mortgages from private institutions during credit contractions and selling them during periods of credit expansion to exert a similar impact on the economy.

Subsidy programs can also be used in a cyclical manner. However, such use presumes that a rationale for the programs exists in general terms, and that the proper timing of expenditures is coincidental with cyclical stability needs. If there is no basic reason for subsidies, a misallocation of resources would result. This could be more costly than increased cyclical fluctuations.

Finally, taxation policy could, in principle, also be used to influence housing cycles. For example, tax shelters for income on new rental units could be allowed only in cyclically appropriate periods. But the instrument is very crude: the time lags may be too long or variable to provide the desired result, and the effect on construction could be quite unpredictable. This approach might also lead to artificial bunching or postponing of construction which would generate its own cyclical instability. Problems associated with the use of this type of measure are typical of all tax policies; such policies are inappropriate for cyclical

stabilization, although they can obviously be used to influence secular trends.

Thus, the three primary candidates for cyclical stability programs are direct lending in the form of 'unrestricted lending' to alleviate short term private credit gaps likely to be caused by a strong application of monetary policy; housing subsidies if such assistance is desirable in its own right; and secondary market banking activities where the agency purchases existing mortgages from primary mortgage lenders who would then be expected to utilize their fresh inflow of funds for additional mortgage lending.

3 HOUSING CONDITIONS AND FUTURE TRENDS

This Chapter reviews the substantial improvement in housing conditions in Canada since the Second World War and describes the outlook for housing markets in the 1980's.

3.1 Housing Conditions

The steady upward trend in housing starts and residential construction expenditure since the Second World War has been generated in large part by a tremendous backlog in unsatisfied housing demand at the beginning of the period, by steadily increasing prosperity since the War, and by the postwar baby boom. These forces combined to propel housing starts from an annual average of 45,000 units in the 1940-45 period to an annual average of 101,000 units in 1951-55, 150,000 units in 1962-66, 200,000 units in 1967-71, and 250,000 units in 1972-76.

This sharp increase in housing starts has created an unprecedented improvement in Canadian housing standards. These changes are illustrated in Table 3.1.1 which shows the vast improvement in the physical quality of housing and increased space per household. The table indicates that doubled families, i.e., more than one family sharing a household, have declined from 9.4 per cent of all households in 1951 to 2.1 per cent in 1976, and that the number of households with more than one person per room has declined from 18.8 per cent to 4.3 per cent during the same period.

The table also indicates that dwellings lacking major facilities, which can be taken as a rough indication of dilapidated dwellings or dwellings in need of major repairs, declined from approximately 40 per cent of all dwellings in 1951 to approximately 2 to 3 per cent in 1976. Not only do these changes demonstrate substantial improvements in housing conditions but they also indicate an extremely high absolute quality. The

Table 3.1.1

Improving Housing Conditions in Canada
(numbers in thousands)

Measures of Housing Conditions	1951 Households No.	1951 Households %	1961 Households No.	1961 Households %	1971 Households No.	1971 Households %	1976 Households No.	1976 Households %
Crowding								
Families not maintaining their own household	321	9.4	236	5.2	172	3.4	123	2.1
Dwelling with more than one person per room	642	18.8	751	16.5	569	9.4	302	4.3
Inadequacy								
No piped hot and cold water	1,470	43.1	904	19.9	442	7.3	215	3.0
Not exclusive use of toilet	1,222	35.9	955	21.0	415	6.9	129	1.8
Not exclusive use of bath	1,471	43.2	1,042	22.9	548	9.1	216	3.1

Sources: 1951, 1961 and 1971 Census of Canada and 1976 Survey of Household Income and Family Expenditure

percentage of doubled families, for example, is below that normally considered to be voluntary doubling, and the number of dwellings lacking basic facilities or 'over-crowded' is remarkably low.

Two other indications of how well Canadians are housed are the growth in non-family households, and the reduction in the age of new home purchasers. The tremendous volume of construction during the last decade, when housing starts exceeded net family formation by approximately 100,000 units a year, enabled a sharp increase in non-family household formation and a reduction in the age of new home-buyers. Since 1961, non-family households have accounted for 33 per cent of new household formation (since 1971 for 35 per cent) and non-family households now account for 22 per cent of all households.

Although absolute figures are not available, it is clear that the age of children leaving the family home to seek their own accommodation has fallen steadily, and that newly divorced and widowed persons have increasingly occupied their own dwellings rather than live with other family members. Since 1971, the average age of the head of the household purchasing a new NHA home has declined almost three years to 30.7 years, and households whose heads are under 30 now account for 53 per cent (and those whose heads are under 35 for 76 per cent) of all new NHA homepurchasers.

These figures indicate that not only have housing standards risen greatly but that housing is both extremely available and affordable since much of the net increase in housing demand is 'non-traditional' and not a result of new family formation.

Further evidence on the affordability of housing for Canadians is provided by Statistics Canada, Urban Family Expenditures Survey, which shows that the percentage of income spent on shelter by homeowners was 15.1 per cent and by renters was 16.3 per cent in 1976. These exact numbers are suspect because of a number of conceptual problems such as the imputation of rents and

varying financing arrangements for homeownership, but even as an approximation they indicate the average proportion of income spent on housing is substantially below the 25 to 30 per cent rule of thumb.

Moreover, as Table 3.1.2 indicates, the real cost of housing, in terms of the relationship between housing costs and family incomes, has not noticeably deteriorated during the 1970's. As the table shows, family income rose approximately at the same rate as new house prices and mortgage carrying costs, and faster than the rental and cost of ownership indices, although there was a period in the mid-70's when increases in family incomes lagged behind increases in new house prices and mortgage carrying costs.

Despite the extremely high quality and general affordability of housing, certain groups are often singled out as experiencing hardship. For one such group, first time homebuyers, the evidence is ambiguous. Affordability appears to have declined because the combination of rising house prices and rising mortgage costs generated a faster increase in housing payments for new homebuyers than in family disposable incomes. However, part of this increase was the result of the 'tilt' problem where accelerating inflation increases the financial burden for new home purchasers during the acceleration period and shortly thereafter, but not in the longer run if the inflation rate levels or declines.

Despite this decreased short term affordability for new homeownership, however, the average age of NHA homebuyers declined steadily over the decade. Finally, the mortgage interest and property tax credit program should mitigate the reduction in affordability, to the extent it occurred, for first time homebuyers.

On the other hand, for a significant minority of households with low incomes, the hardship is real. An indication of this is that 57 per cent of renters in the lowest income quintile and 36 per cent of renters in the second lowest income quintile (and 23 per cent of renters overall) spent over 25 per cent of their

Table 3.1.2

Selected Housing Indices
(1971 = 100)

Year	Rent	Cost of Ownership	New House Prices	Mortgage Carrying Costs	Average Family Income
1971	100	100	100	100	100
1972	107	108	109	107	107
1973	103	119	132	133	124
1974	105	130	171	195	143
1975	111	144	184	213	161
1976	118	163	203	241	189
1977	126	187	210	225	205
1978	133	196	215	235	228

Sources: Statistics Canada, CMHC estimates

income for rent in 1976, and, as Table 3.1.3 shows, households in the lowest income quintile spent an average of 41 per cent of their income for housing in 1974.

Although these figures indicate low income households are experiencing financial hardships, the figures should not be strictly taken as evidence of a housing problem, because the accumulated data clearly indicate that housing quality, availability, and affordability are high. Instead, the high proportion of income spent on housing by low income families indicates that these families have primarily an income problem rather than a housing problem. It is also worth noting that during the last decade the proportion of income spent on housing by the lowest two income quintiles remained relatively unchanged despite the magnitude of housing and other assistance for low income households over the period.

Notwithstanding the conclusions of the previous paragraph there are some low income households faced with a housing problem, in addition to a low income problem. One such group is households that not only pay a high proportion of their income for shelter, but whose shelter is physically dilapidated and requires rehabilitation to bring it up to acceptable standards. Other groups of low income families are the native peoples and rural households that may have housing problems in addition to income problems, in the sense that higher incomes might not ensure adequate housing would be built for them. However, these groups are increasingly exceptions to the general rule and consideration of them should be separate from the typical low income problem.

A further qualification about the magnitude of the low income problem is that the above figures may over estimate the situation. This happens for four reasons. First, for homeowners, the exclusion of net imputed rent from income adds an upward bias to the figures. Second, different households have different tastes and preferences, and a high proportion of income spent on housing may in fact reflect a disproportionate

Table 3.1.3

Ratio of Shelter Costs to Income in
Census Metropolitan Areas, for
Homeowners with and without Mortgages, and Renters

Income Quintiles	Average for all Households	Average for Homeowners Without Mortgage	Average for Homeowners With Mortgage	Average for Renters
1st	.41	.34	.53	.43
2nd	.23	.14	.32	.22
3rd	.18	.10	.23	.17
4th	.14	.08	.18	.13
5th	.11	.06	.14	.10

Source: CMHC Survey of Housing Units, 1974

preference for housing consumption, although this is less likely to happen among households in the lower income quintiles. Third, there is nothing necessarily sacred about the 25 per cent ratio and to the degree that a higher ratio for hardship is considered socially acceptable, the selection of the 25 per cent ratio overstates the size of the problem. Fourth, since homeownership also contains an investment as well as consumption element, young households have increasingly come to 'overinvest' in housing on the expectation that their incomes will rise in the future and their housing will then be 'affordable'.

CMHC has attempted to incorporate a number of these considerations into estimates of financial hardship and housing quality problems. The procedure, based on an analysis of Canada's twenty-three major urban areas, indicates that 155,000 households live in inadequate and/or crowded dwellings and would have to spend over 30 per cent of their income to obtain suitable and adequate shelter; 82,000 of the above 155,000 households would have to move to obtain affordable, uncrowded, and adequate shelter while the remaining 73,000 households live in units which could be improved; 283,000 households live in uncrowded and adequate shelter but are paying over 30 per cent of their income to obtain such accommodation; and 486,000 households live in crowded and inadequate shelter but could probably afford to pay less than 30 per cent of their income to reside in uncrowded and adequate shelter.

From the above it is clear that Canadian housing standards are extremely high, that housing quality is very good and housing on the whole is quite affordable. Moreover, although a number of households still have housing difficulties, the amount of 'involuntary hardship' associated with housing is often overestimated. Most actual hardship is not due to the unavailability of adequate housing, although there are some special instances of this, but is due to the existence of a significant minority of Canadians with incomes too low to enable them to acquire suitable housing at an appropriate housing expenditure to income

ratio. Finally, in both urban and rural areas there is scope for improving what housing problems remain through greater emphasis on renovating and upgrading the existing housing stock, as opposed to the use of new construction.

3.2 Outlook for the 1980's

The foregoing discussion indicated that the strong upward trend in housing starts since the Second World War was generated by a high pent-up demand for housing, rising real incomes, and favourable demographic forces. In contrast, the outlook for the 1980's is predicated on the absence, in whole or in part, of these conditions; an accelerating decline in housing activity is anticipated during the decade.

A very significant factor in the outlook for the eighties is the enormous past accomplishments of the housing industry, the financial industry, and government. Together these groups have produced a virtually unsurpassed stock of housing for Canadians, with almost no significant pool of unsatisfied housing requirements. Moreover, there is little scope for generating additional net demands from increases in the rate of non-family household formation, or from accelerating housing demand. Thus, little backlog of unfilled housing requirements exists to support the housing industry in the 1980's in the way it did in the past.

Another very substantial force in the past secular growth was the prolonged upward trend in real family incomes. Although the overall economic outlook for the 1980's is relatively optimistic, the rate of growth generally anticipated is below that of the past two decades. Thus it is unlikely there will be additional impetus in demand from a sharp acceleration in the growth of real incomes.

Finally, an important aspect of the outlook for housing in the 1980's is the emergence of negative demographic influences. The importance of demographic influences

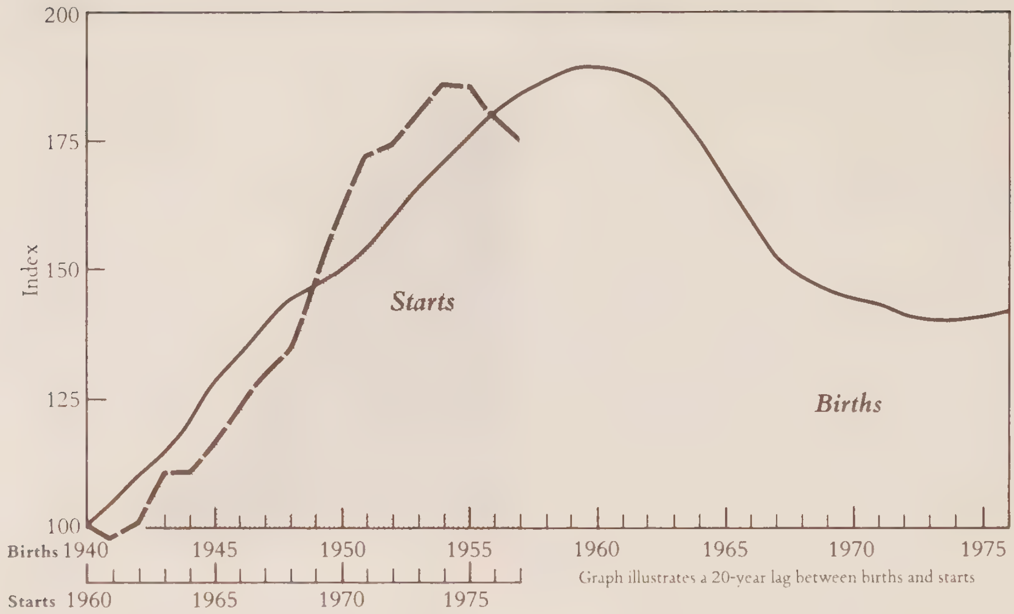
can be seen from Figure 3.2.1 which indicates the parallel movement between housing starts and births with a twenty year lag.

The relationship between housing starts and population is obvious, with a rising population in the 15-24 age bracket primarily generating an increase in the demand for apartments and an increase in population in the 25-35 age bracket generating an increase in homeownership demand. A less direct relationship also exists in the over 55 age bracket, as an aging population over 55 and especially 65 tends to increase the demand for multiple unit housing and simultaneously increases the availability of existing single family housing from which they move.

The dominent demographic aspects of the 1980's are the expected declines in net household formation in the 15-24 and 25-34 age brackets. In the 1976-81 period, for example, net household formation in the 25-34 age bracket is expected to decline by 23,000 households annually and net household formation in the 15-24 age bracket is expected to decline by 10,000 households annually compared to the previous 5 year period. Overall, net housing requirements are expected to peak in 1981 at 237,000 units and then decline steadily over the decade to 165,700 as sharp declines are expected in net household formation in the primary house-buying age brackets. The implications of these declines for housing starts are shown in Figure 3.2.2.

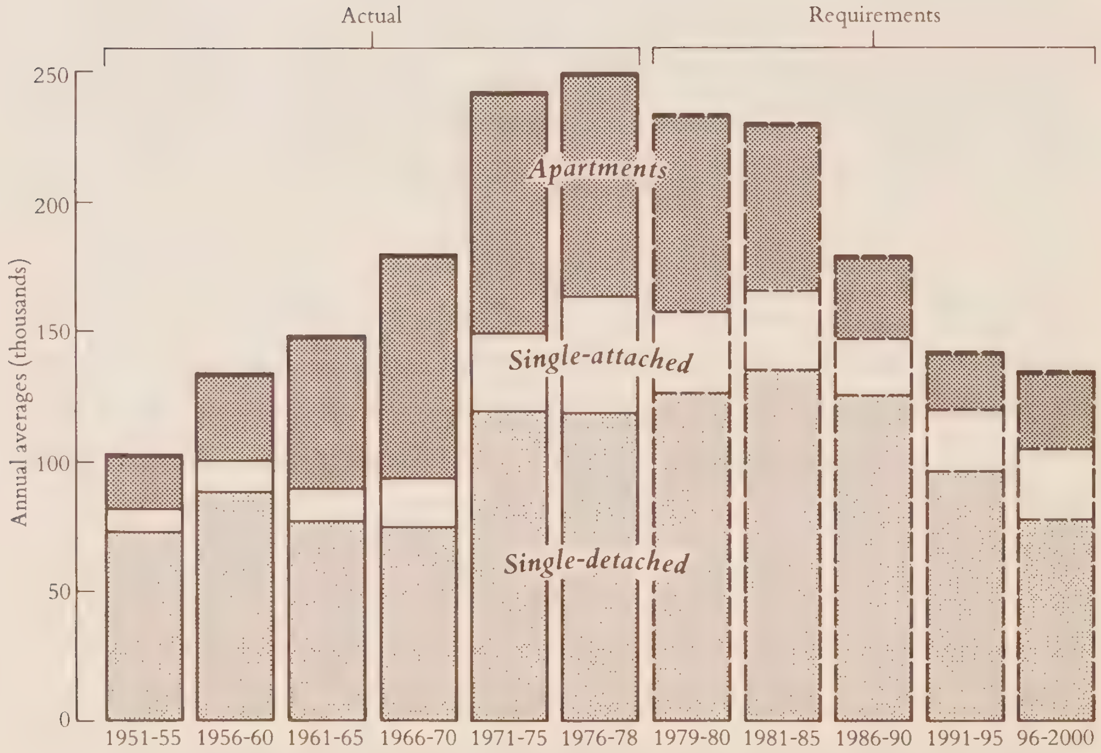
It should be pointed out that these predictions are based solely on demographic trends; a reduction in the rate of growth of real family incomes would lower them. Moreover, the relationship between demographic forces and housing starts is elastic in the sense that there is a long term relationship between them, but considerable year to year variation based on specific economic factors. Nevertheless, the sharp decline in demographic influences, together with the absence of a backlog of unsatisfied housing requirements, indicates the volume of housing starts will fall substantially from its very high levels of the past decade.

Figure 3.2.1



Historical trend of births 1940-1976 and starts 1960-1977

Figure 3.2.2



Historical starts and requirements, projections by type

Within the housing market itself there is likely to be considerable variation in the response of single and multiple dwelling construction. Since the sharp decline in net household formation will come first in the 15-24 age bracket, the multiple sector will experience declining demand first. This decline in demand, however, is unlikely to reduce construction activity significantly in the multiples sector since rent controls have already virtually eliminated private unsubsidized multiple rental construction and since some of the decline in the youth demand will be offset by the growing demand of the elderly for multiple unit housing.

The brunt of the unfavourable demographic forces should begin to hit the single family market just before the middle of the 1980's and consequently single family housing starts can be expected to decline substantially after that. To some extent, the decline will be accelerated by the rising proportion of the population over 55 (and especially 65) since some of their existing housing will become available to satisfy younger housing demands.

Finally, the property tax and mortgage interest tax credit program will affect housing markets by increasing the demand for homeownership and shifting demand away from the rental sector. Estimates of the impact of the program on housing starts vary considerably, but appear to be in the range of 20,000-35,000 additional ownership units annually over a 4 or 5 year period. Although rental demand will decline, rental starts are unlikely to be largely affected as long as rent controls remain because of their small initial base. However, if rent controls were to be removed, the increase in rental starts following the removal would be less than in the absence of the tax credit program. Thus, the tax credit program should provide support for the housing industry until the middle of the decade and mitigate but not eliminate the natural decline in housing activity until then. This support will end toward the middle of the decade at approximately the same time as the demographic support deteriorates, generating a

substantial decline in housing starts in the middle of the decade.

It is important to remember, however, that while the predicted decline in housing activity in the decade has undesirable employment implications, it does not have undesirable social implications because it is simply a reflection of a very high existing standard of housing and declining rate of population growth in the relevant age brackets. Policies designed to artificially stimulate housing on a secular basis in this period or to prevent the anticipated downturn would therefore be economically inappropriate.

The purpose of this Chapter is to describe the various housing programs of the federal government. Section 4.1 provides a brief overview; sections 4.2 to 4.7 focus on programs offered by CMHC; and section 4.8 is devoted to programs which are offered by other federal agencies or operated through the Income Tax Act.

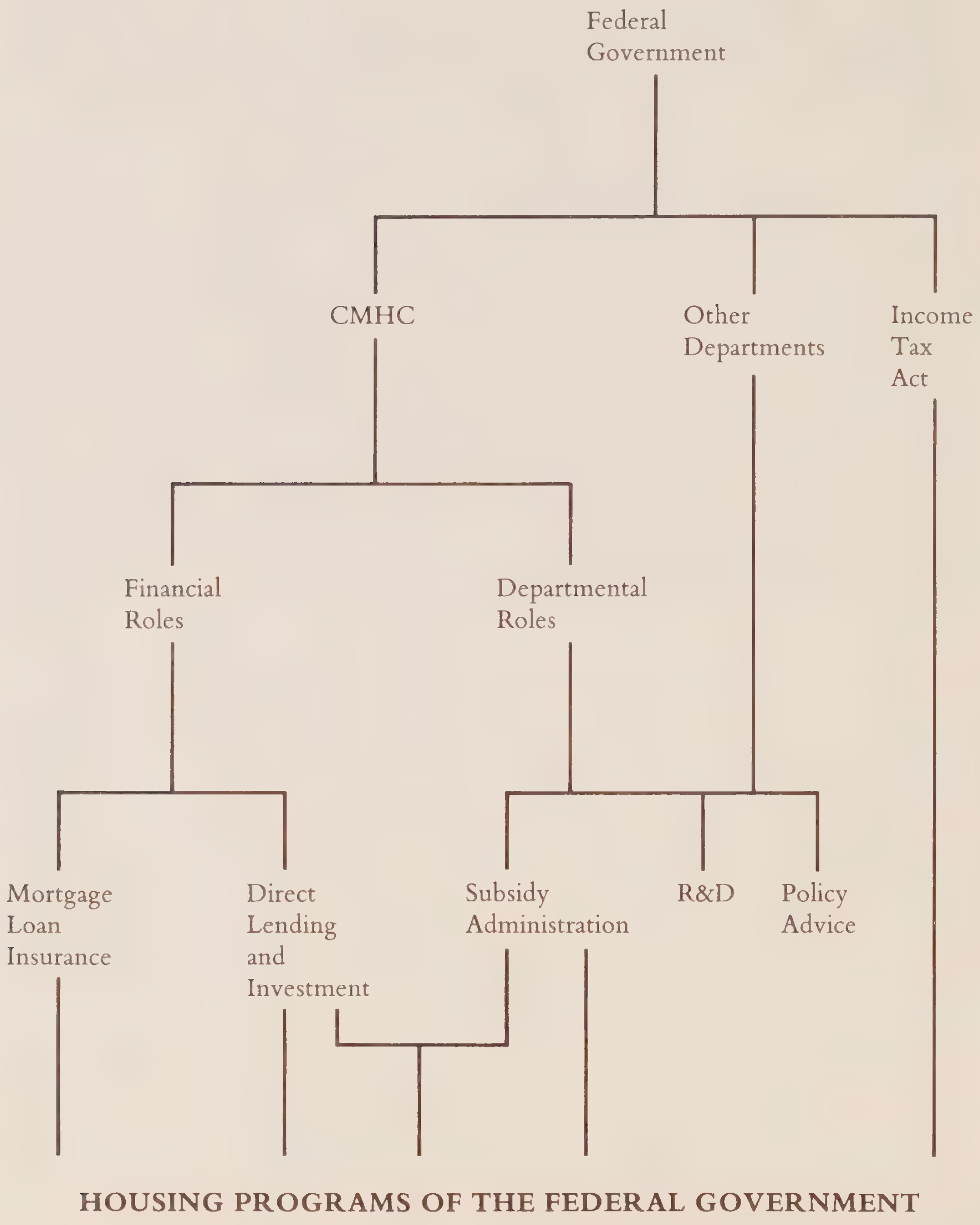
4.1 Overview of Programs

The federal government exerts a significant impact on housing and mortgage markets through a number of vehicles, the two most important of which are CMHC and the income tax of Canada. A schematic view of federal involvement is set out in Figure 4.1.1. CMHC is a crown corporation which performs both financial and departmental roles on behalf of the government. These two roles warrant further discussion.

In its financial capacity or role, CMHC functions as an insurer and as a financial intermediary. As an insurer, CMHC operates the Mortgage Insurance Fund. Fees paid by borrowers are added to the fund, out of which reimbursement to lenders occurs if the borrower defaults. As a financial intermediary of the government, CMHC borrows funds from the Consolidated Revenue Fund of the government in accordance with terms and conditions established by the Minister of Finance. This borrowing has been at a rate 1/8 of one per cent higher than the cost to the government of acquiring these funds on the open market. CMHC, in turn, currently lends these funds at the same interest rate as that charged by private lenders for loans insured by CMHC. This is a market determined interest rate with the spread between CMHC's cost of obtaining funds and its lending rate being used to cover the costs of administering the loans. For the purposes of subsequent discussion, the interest rate which CMHC charges will be referred to as the NHA direct lending rate.

Figure 4.1.1

Overview of Federal Government Housing Involvement



In its role as a government department, CMHC administers subsidies to various groups or individuals, provides policy advice, and conducts research. Funds required for these purposes are provided to CMHC through annual allocations appropriated by Parliament.

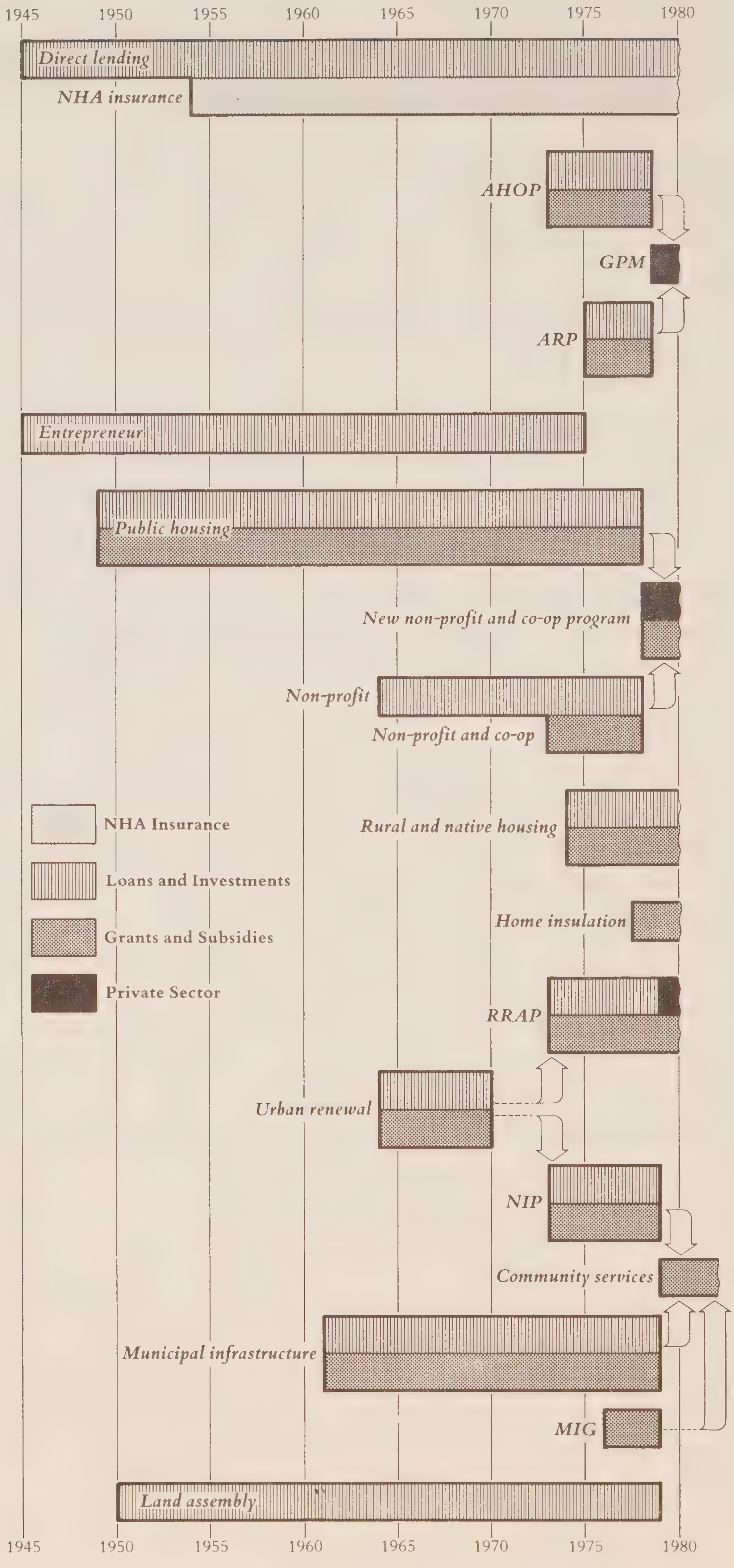
In some programs, CMHC combines its financial role with its departmental role. For example, some programs involve direct lending by CMHC with a 'write down' or reduction in the rate of interest on the mortgage financed out of the departmental, or subsidy, budget of the Corporation.

The integration of the financial and departmental roles of CMHC in the design of housing programs is highlighted in Figure 4.1.2. The two financial functions -- direct lending and mortgage insurance -- are shown at the top of the figure, with loan insurance being introduced in 1954. The evolution of the programs of CMHC and the use of the lending and subsidy functions in the design of the programs is also shown in the figure.

Using the time dimension, notice the early concentration on public housing and land assembly, with both programs essentially defunct by 1979, except for one variation of public housing which is still active in a few provinces. Programs proliferated beginning in the early 1960's. Most of these programs were substantially modified or terminated by 1979. For example, Urban Renewal was abandonned by 1970. The Residential Rehabilitation Assistance Program (RRAP) and the Neighbourhood Improvement Program (NIP) were then substituted for Urban Renewal. RRAP now operates mainly with private sector lending and a subsidy; and the grant component of NIP, which is now defunct, has been rolled into the current Community Services Program, which is also a consolidation of the Municipal Infrastructure Program, and the Municipal Incentive Grant (MIG).

Another set of programs which remains is the 'new' non-profit and co-op programs, which grew out of public housing and earlier non-profit and co-op programs. The other two sets of programs currently administered by

Figure 4.1.2



Evolution of CMHC programs

CMHC are Rural and Native Housing and home insulation programs. The insulation programs are administered on behalf of the Minister of Energy, Mines and Resources.

Most of the remaining programs involve only the subsidy role, with private sector lending substituted for CMHC direct lending. Examples of this kind of program withdrawal are the short-lived Assisted Home Ownership Program (AHOP) and Assisted Rental Program (ARP), which now consist of nothing more than an undertaking to insure, under the National Housing Act, Graduated Payment Mortgages made by private lenders. This represents neither an innovation by CMHC nor, for that matter, a housing 'program' since the private sector had earlier been making escalating payment mortgages which were insured by private mortgage insurers, although there is a hidden subsidy cost in CMHC's activities in this area. The loan insurance operation of CMHC has also been used in program design in a number of other similar ways, not shown in the figure.

The general trend recently is toward program withdrawal and substitution of private for public sector lending. It should be noted that having government programs which make use of mortgage loan insurance does not require that government necessarily perform the insurance function itself, which could be performed by private insurers on behalf of the government, in cases where an explicit government subsidy of the activity is called for. This type of arrangement would be similar to the provision of a government subsidy in a program which makes use of private sector lending. The relevant details of the major housing programs of CMHC operated from 1945 to 1979 are given in the following six sections.

4.2 Mortgage Loan Insurance and Direct Lending

The mortgage loan insurance and direct lending operations of CMHC are desbribed in the following two subsections. The third subsection describes Graduated Payment Mortgages which are made by private lenders and insured under the National Housing Act.

Mortgage Loan Insurance

Loans which are made by private approved lenders such as banks, life insurance companies, and trust and loan companies and which are secured by a first mortgage may be insured against default by CMHC. An insurance fee of 1 per cent of the total loan for a loan advanced in instalments or 7/8 of one per cent for a loan advanced in a lump sum is added to the principal of the loan. Borrowers can usually obtain a lower interest rate, longer amortization period, and a higher loan-to-value ratio for low or moderate priced housing than is available in the conventional non-CMHC-insured lending field. New homes must meet CMHC construction standards and existing homes must meet CMHC property standards. Eligible borrowers include commercial builders and individuals or co-operative associations either constructing new housing or purchasing existing housing to occupy for themselves. Builders constructing new rental units are also eligible but pay a slightly higher insurance fee of 1.25 per cent for an instalment loan or 1.125 per cent for a loan advanced in a lump sum.

NHA insured loans are normally for terms of five years but may be renewed at a renegotiated interest rate. The standard amortization period is 25 years with periods of up to forty years allowed in some circumstances. The maximum loan is 95 per cent of the first $50,000 of lending value for a new or existing home plus 75 per cent of the balance to a maximum of $70,000. The borrower in the case of an owner-occupant must have an equity of at least 5 per cent and total carrying charges including property taxes cannot exceed 30 per cent of his gross income. A 10 per cent equity is required for rental loans.

If a borrower defaults on an NHA insured mortgage, the normal procedure is for the lender to foreclose and pass the title of the property to CMHC which then reimburses the lender for the principal outstanding on the mortgage, unpaid interest on the principal, and other costs such as legal fees and unpaid property taxes, fire insurance, and public utilities.

CMHC mortgage loan insurance has been in existence since 1954. Indeed, as discussed in Chapter 2, the mortgage loan insurance program has contributed significantly to the development of the private mortgage lending industry in Canada. However, at the present time two private firms -- Mortgage Insurance Company of Canada (MICC) and INSMOR Mortgage Insurance Company -- also offer mortgage loan default insurance. Both have grown rapidly in recent years. For example, the aggregate value of loans insured by private mortgage companies increased from $4.7 billion in 1974 to over $15 billion by the end of 1978. By contrast, CMHC had roughly $20 billion of loan insurance in force by the end of 1978.

There are three general differences between private mortgage insurance plans and NHA mortgage insurance. First, CMHC establishes maximum loan amounts and lending values, whereas private insurers such as MICC do not specify maximum lending values or loan amounts for some classes of property, although the allowable maximum loan-to-value ratio is set so as to vary inversely with the lending value of the property. Second, NHA insured loans generally take longer to be approved than privately insured mortgages. Third, the inspection process and the enforcement of standards is generally considered to be more stringent and rigid for NHA insured loans than for privately insured loans.

Despite these differences, NHA and private insurance are relatively close substitutes. However, because maximum insurable levels are set at $70,000 by CMHC, private insurance companies do not have government competition on properties which have lending values in excess of this maximum. Given the rapid rise of activity in the private sector mortgage loan insurance field, the original objective of the loan insurance program, of providing a sound environment for mortgage lending, has been largely accomplished.

Three other objectives of government loan insurance are often mentioned. First, government loan insurance has been used to help facilitate private sector adoption of mortgage schemes such as the Graduated Payment Mortgage

discussed in the next subsection. Second, the insurance system has been used as a vehicle for the propogation and adoption of site planning guidelines, airport and rail noise criteria, amenity guidelines, and higher energy efficiency requirements. Related to this is the notion that, because of the CMHC inspections, purchasers of dwelling units have some guarantee of the quality of their dwelling unit. Third, the terms to qualify for federal loan insurance have periodically been changed, occasionally in a manner to influence the cyclical availability of private mortgage credit. Because the variations have almost always been in the direction of greater ease, this technique has not shown the reversibility that a proper stabilization tool should. Consequently, its anti-cyclical role has been relatively minor.

Direct Lending

Under Section 58 of the National Housing Act, CMHC may make any type of loan that may be made by an approved lender, if the loan is not available to a satisfactory applicant through an approved lender. While this program has been used extensively in the past, especially during the period when the level of NHA interest rates was determined by the federal government, direct loans are currently available only on a very limited basis in geographical areas that are not normally serviced by approved lenders. Because of the well developed nature of the private mortgage industry, as evidenced by its provision of about $14 billion in residential mortgage loans in 1978, this residual role for CMHC will likely continue to be small.

From the perspective of the borrower, a direct loan from CMHC is virtually identical to a mortgage loan from an approved lender. The lending terms are the same and the borrower is required to pay an insurance fee of the same amount as an approved lender would collect.

Graduated Payment Mortgage

In general, a mortgage instrument provides for payment by the borrower of an annual fixed sum sufficient to pay interest costs for the year and to repay the principal over the amortization period of the loan. If prices are stable, the burden of the mortgage payments, in both real and monetary terms, is spread evenly over the amortization period of the loan. In periods of inflation, however, the mortgage payment burden is spread evenly in monetary terms, but in real terms declines year by year over the amortization period. As well, lenders wish to maintain the real value of their asset (the mortgage) during inflation and can be expected to demand an inflation premium equal to the expected rate of inflation. As a result of these forces, level payment mortgages in an inflationary, high interest rate environment result in a stream of payments which fall steadily in real terms, but commence at a level which excludes many home-buyers or investors in rental property from the market.

Early CMHC programs attempting to overcome this problem were the Assisted Home Ownership Program and the Assisted Rental Program which are discussed in subsequent sections. The current method is to insure Graduated Payment Mortgages made by private lenders against default and to make direct Graduated Payment Mortgage loans on a residual basis. New and existing rental and owner-occupied accommodation subject to regional price ceilings set by CMHC are eligible. Neither the direct lending nor the insurance-related Graduated Payment Mortgage programs presently are very important in terms of housing units. The former involves less than 100 units and the latter involved roughly 4,000 units approved in 1978.

Under the Graduated Payment Mortgage offered, initial borrower payments from a non-level payment mortgage at market interest rates are reduced by $2.25 per $1,000 of the mortgage principal. Annual payments then escalate by an amount equal to five per cent of the payments in the previous year. The program offers no

subsidy, but rather shifts the timing of mortgage payments.

The advantage of such a system is that it provides an equalized mortgage payment in real terms over the life of the mortgage. However, the nominal income required to support the payments at the end of the life of the mortgage is much higher than the initial income required. This is not a serious problem in an inflationary period, because one would expect that the income of the borrower will increase at the rate of inflation, but, under some circumstances, it might increase the risk of default relative to the traditional level payment mortgage because the outstanding loan balance is larger under this scheme, because the continued inflation is not certain, and because the borrower's income may not increase in line with inflation. For this reason and because of general uncertainty with respect to the lending technique, the private sector has been reluctant to introduce such a lending instrument. CMHC intervention thus allows the private sector firms a chance to evaluate this innovation without risking their own resources, although only at an unknown hidden cost.

4.3 Home Ownership Incentives

The activities described in the previous section have a positive impact on both home ownership and the supply of rental accommodation. Other programs of CMHC having a direct impact on home ownership are described in this section. These programs are home buyer grants which were offered for a one-year period ending October 31, 1975 and the recent Assisted Home Ownership Program which was in effect in various forms from 1973 to 1978. Another ownership program of much lesser importance, Building Co-operatives, is described at the end of this section. Other provisions of the federal government which have an impact on home ownership, particularly provisions in the Income Tax Act, are described in the final section of this Chapter.

Home Buyer Grants

First time purchasers of a dwelling unit were eligible for a federal grant of $500 if the dwelling unit was newly constructed and priced below a maximum set by CMHC on a local basis. The objective of this program was to increase the demand for modestly priced owner-occupied dwelling units and to stimulate the economy. The program applied to units occupied between November 1, 1974 and October 31, 1975. Total expenditure on this program was $46.8 million.

Assisted Home Ownership Program

When the Assisted Home Ownership Program was first introduced in July, 1973, CMHC offered a mortgage for up to 95 per cent of the lending value amortized over 35 years. Its most important feature, however, was a subsidy of up to $300 per annum which was increased twice and extended to units financed by approved lenders, before interest-reducing loans were substituted in December, 1975. Grant payments based on commitments under this program are expected to be roughly $15 million to those with direct loans from CMHC and $12 million to those with loans from approved lenders over the period 1979-84.

Under the revised program, households of two or more persons purchasing new moderately-priced homes were eligible for interesting-reducing loans. Maximum permissible house values for participation were established on a local basis. Mortgages were written at the current NHA rate but the AHOP loan was sufficient to bring the effective interest rate down to 8 per cent in the first year. The loan was advanced to the homeowner in monthly instalments and was interest-free for the first five years, with monthly advances decreasing each year by one-fifth of the amount loaned in the first year. At the end of the fifth year, monthly payments to the homeowner ceased and he could choose between paying off the loan in a lump sum from savings, increasing the first mortgage at the renewal time, or repaying by monthly instalments to CMHC.

Households with at least one dependent child were also eligible for grants, depending on family income. If mortgage payments and property taxes were still more than 25 per cent of gross income after allowing for the interest-reducing loan, the family qualified for an AHOP subsidy of up to $750 in the first year. Estimated expenditures under this program including the interest costs from interest free loans, grants and administrative costs are expected to be $83 million over the period 1979-84.

As part of a program of fiscal restraint in 1978, CMHC was required to reduce its direct lending and subsidy commitments. As of May 1, 1978, the existing version of AHOP was terminated and a transitional AHOP program introduced. This consisted of a full interest-bearing second mortgage which provided cash advances and a repayment schedule corresponding to that in the previous AHOP program. These second mortgage funds were loaned directly by CMHC, without any indirect interest subsidy or direct cash advance. The transitional AHOP program was designed to compensate for a general unwillingness of private lenders to make non-level payment mortgages. AHOP was replaced by NHA-insured Graduated Payment Mortgages in 1979. These were discussed in the previous section.

Building Co-operatives

A building co-operative is usually composed of a small group of persons who pool their resources to achieve individual homeownership at moderate cost. Under Section 40 of the National Housing Act, CMHC offered subsidies to building co-operatives which were shared on a 75/25 basis with the provinces and which reflected the AHOP terms available at the time the project was approved. The program was relatively small with less than 4,000 units being approved and was primarily operated in Nova Scotia and New Brunswick. Expenditures based on previous commitments are estimated to be roughly $3 million over the period 1979-84.

4.4 Public, Co-operative, and Other Rental Programs

Since the late 1960's, CMHC has shifted its primary focus to one of providing assistance to low income households. Numerous programs have been offered and the emphasis on different types of programs has been constantly evolving. At the present time, emphasis is on the provision of a subsidy toward builders' project operating costs. The subsidy is equivalent to the difference between monthly mortgage payments at the current mortgage rate of interest and the payment required had the mortgage rate been two per cent. Also, many of the older programs still exist. However, since late 1978, these programs have been scaled down significantly or withdrawn. This section reviews each of the major programs.

Public Housing

Under Section 43 of the NHA, CMHC provides a financial intermediary service to provinces, municipalities, or public housing agencies by providing loans at the direct NHA lending rate for up to 90 per cent of the total costs of a public housing project. These developments may include family housing units, hostel or dormitory accommodation provided through new construction, or the purchase and conversion of existing buildings. For these projects, CMHC also plays a departmental role under Section 44 of the National Housing Act by making grants for up to 50 per cent of the operating losses on the project, including debt service.

An alternative procedure for providing public housing is available under Section 40 of the National Housing Act. Under this section, CMHC participates directly with provincial governments in the development of public housing projects by providing 75 per cent of the capital costs. The remaining 25 per cent of capital costs are assumed by the province or jointly by the province and the municipality. The profits and losses resulting from the project are shared in the same proportion as capital costs.

The objective of both programs is to provide dwelling units to those with low incomes based on their ability to pay. In both cases, CMHC provides subsidies in its departmental role and makes investments in mortgages, under Section 43, or actual public housing projects, under Section 40, in playing its financial role.

Until very recently, both programs were very large, with the subsidy portion of CMHC involvement being over $105 million in 1978. In addition, total loan commitments under Section 43 were $176 million in 1978, while commitments under Section 40 were roughly $126 million. However, both programs were dramatically scaled down in 1979 and largely replaced by the differential interest non-profit and co-operative housing programs introduced in 1978. However, expenditures under these programs because of previous commitments will continue to escalate over the forseeable future. Over the period 1979-84, annual expenditures are estimated to be roughly $300 million.

Rent Supplement Program

Under Section 44(1), CMHC pays 50 per cent of their losses to provinces who lease dwelling units from private landlords for public housing purposes. In this program, CMHC plays a departmental role by paying explicit subsidies to the province. No loan by CMHC is required. The important feature of this program relative to public housing is that the units are leased from the private sector. Thus, the program involves no new construction directly, although it may indirectly by increasing effective rental demand. As well, landlords leasing units cannot lease more than 25 per cent of the units in the project to the province for public housing purposes. This has the effect of mixing low income households in with those paying market rents. Approximately 10,500 dwelling units are currently covered under this program and this is expected to escalate to roughly 34,000 units by the end of 1984. Total expenditures over the period 1979-84 are expected to be approximately $200 million.

Entrepreneur, Non-Profit, and Co-operative Housing

Under Section 15 of the National Housing Act, direct CMHC loans were available to any person or organization providing housing to elderly persons or low income groups at below market rents. Up to 95 per cent of the lending value was provided at interest rates of 8 per cent. These interest rates were below the direct NHA interest rate so that a direct subsidy was involved. This program was discontinued in 1975.

Under Section 15.1 of the National Housing Act, loans were made available to non-profit organizations formed exclusively for charitable purposes or for municipally owned non-profit companies. Loans were available to cover 100 per cent of the lending value at the same subsidized interest rate discussed in the previous paragraph. In addition, CMHC provided a direct grant not exceeding 10 per cent of the cost of the project. This program was discontinued in 1978 and replaced by the Differential Interest Program discussed later in this section.

Assistance for a non-profit housing co-operative with members of low and moderate incomes was available under the same terms as other non-profit companies discussed above. This program was also discontinued in 1978. Expenditures for these programs based on previous commitments are expected to be roughly $25 million over the period 1979-82.

Assisted Rental Program

The Assisted Rental Program was introduced in 1975. Under this program, CMHC made subsidies to encourage the construction through private investment of moderately priced rental housing units. Builders were expected to obtain mortgage funds from the private sector.

The maximum subsidy payments were $900 per unit per year. These contributions were reduced to zero in equal increments over a period which could not exceed 15

years. In return for the subsidy, entrepreneurs agreed to limit the rent charged for the units. Approximately 21,500 units were approved for construction in 1975 under this program. Although the program was discontinued in 1976, expenditures based on previous commitments are estimated to be roughly $50 million over the period 1979-85.

The 'modified' Assisted Rental Program, introduced in 1976, replaced the 1975 program. This modified program was very similar to its predecessor. However, instead of providing a grant, CMHC offered an interest free loan to offset the losses experienced by investors when market rentals were less than sufficient to provide for full recovery of project costs.

Interest free loans up to a maximum of $1,200 per unit in the first year were available with annual loans being reduced to zero in equal increments over the life of the agreement, which could not exceed 15 years. On expiry of the agreement, borrowers may repay the interest free loans or refinance them with a 10 year mortgage from CMHC at the rates currently charged by approved lenders for NHA insured loans.

Since the inception of the program in 1976, approximately 100,000 dwelling units have been approved. No new commitments from the program are being made, but costs will be incurred by CMHC for a number of years in the future. Cost estimates, based on CMHC's borrowing rate and the dollar value of interest free loans outstanding, plus administration costs, are estimated at roughly $150 million over the period 1979-84.

Differential Interest Contributions - Non-Profit and Co-operative Housing

The central element of the revised social housing policy introduced by CMHC in 1978 is a subsidized housing program providing differential interest contributions to public or private non-profit housing corporations which operate rental housing projects for

persons of low to moderate incomes. Under this program CMHC does not operate as a financial intermediary and make loans. Instead, CMHC provides an explicit annual subsidy towards project operating costs equivalent to the difference between monthly mortgage payments at the market rate of interest and the payment which would have been required had the rate of interest been 2 per cent. Loans for these projects are generally obtained from private lenders and insured against default by CMHC, although CMHC proposes to retain a small residual lending role to ensure that funds are made available in smaller communities where private lenders are not active.

Any operating losses after the CMHC subsidy will be funded by the provinces. However, in cases where the provincial contribution is equal to that provided by CMHC, further losses will be shared equally by the province and CMHC under Section 44 of the National Housing Act.

The current policy is to encourage provincial and private non-profit corporations to operate projects with a mixture of low to moderate income tenants where up to 50 per cent of the units are rented at the prevailing market rate. The additional revenue generated by the higher income tenants is expected to minimize provincial contributions. Only very high cost projects where income mixing is not possible are expected to require the additional subsidies under Section 44. In order to remain eligible for continuing support, any surplus assistance received in a previous year must be returned by the builder to CMHC with the annual operating statement. Presently, the program involves modest expenditures of $4.5 million for the year 1979. However, as the program becomes established and replaces existing programs, CMHC expenditures will increase dramatically. It is estimated that by 1984 the program will involve roughly $200 million in annual subsidy expenditures.

The Co-operative Housing assistance program introduced by CMHC in 1978 is similar to its non-profit counterpart in that annual assistance, delivered through a Differential Interest Contribution under

Section 56.1 of the National Housing Act, is based on the difference between monthly mortgage payments at the market rate of interest, and the payments that would have been required had the market rate of interest been 2 per cent. Loan funds are expected to be obtained from the private sector.

Co-operative housing projects are expected to break even without assistance other than that provided by CMHC. Since provincial assistance and/or Section 44 subsidies will not be available, co-operatives will obtain their required operating revenue by renting up to 85 per cent of the units in each project at, or near, market rental rates. The remaining 15 per cent of the units will be reserved for low income tenants who will pay rents based on the federal rent-to-income scale.

In the initial operating year, rental rates for the higher income tenants will be set at the lower range of market rents for the area in which the project is located. Tenants paying market rates will not be subject to income tests. Since the maximum subsidy will not apply to these units, the surplus can be applied to further reduce the rents of low income tenants.

Low income tenants paying rents based on the federal rent-to-income scale will continue to be eligible for assistance on a project-by-project basis. However, interest assistance for other tenants will be gradually withdrawn after the third year of operation. The withdrawal will be based on a 5 per cent compound increase in the required mortgage payment. Co-operatives will be required to maintain a rental structure for non-income tested tenants that maintains project viability after withdrawal of the Section 56.1 subsidy.

As in the case of non-profit corporations, co-operatives will be required to submit an annual operating statement to the Corporation to qualify for continuing assistance. Any operating surplus at the end of the year must be returned to CMHC with the audited operating statement.

This program is also modest at the current time, with expenditures of less than $1 million for the present year. However, expenditures are expected to increase steadily to a level of over $50 million per annum in 1984.

4.5 Urban Renewal and Rehabilitation

The federal government has been actively involved in urban renewal, dwelling unit rehabilitation, and neighbourhood improvement. Home Improvement Loans are described first in this section, followed by the Urban Renewal program which operated between 1964 and 1969. Two programs were subsequently introduced: the Neighbourhood Improvement Program (NIP) and the Residential Rehabilitation Assistance Program (RRAP). For a while, these programs operated in tandem and involved large federal transfers, but NIP has since been terminated. The types of expenditures which it permitted are now included in the set of activities on which municipalities may make expenditures under the Community Services Program which is described in section 4.6 of this Chapter. Federal obligations continue under the current version of RRAP, with private sector lending largely substituted for CMHC direct program lending. Following the discussion of NIP and RRAP in this section is a description of the two home insulation programs operated by CMHC on behalf of the Minister of Energy, Mines and Resources.

Home Improvement Loans

Under Section 28 of the National Housing Act, CMHC acts in its role as an insurer and provides default insurance to approved lenders making home improvement loans. A maximum of $10,000 for each family unit is available for a wide variety of purposes. The borrower pays an insurance fee of 1 per cent.

The objective of this program is to increase the availability of private mortgage funds for purposes of maintaining and rehabilitating existing dwelling units.

Because private insurers are not involved in this activity CMHC may be removing a market imperfection. However, it should be noted that this program is relatively small with less than 4,200 loans being approved for insurance in 1978.

Urban Renewal

The Urban Renewal Program began in 1964 and was curtailed in late 1969. Further legislation limited its operations to projects approved prior to February, 1973. Grant payments based on previous commitments including administration costs are expected to be roughly $24.5 million over the period 1979-82.

Under this program, CMHC played a departmental role by offering subsidies to municipalities undertaking urban renewal schemes. It also acted as a financial intermediary by providing loans at the direct NHA lending rate to municipalities undertaking urban renewal. The objective of the program was to replace blighted buildings in urban renewal areas with new construction. This approach came under attack for several reasons, the main one being that the program destroyed low quality modestly priced housing and replaced it with higher cost housing and non-residential buildings. As a result, many low income persons were up-rooted from existing neighborhoods and forced to locate elsewhere.

Neighbourhood Improvement Program

The Urban Renewal Program was replaced by the Neighborhood Improvement Program in 1974. In contrast to the Urban Renewal Program which gave assistance for slum clearance, the objective of the Neighborhood Improvement Program was to improve the amenities of neighborhoods and the housing and living conditions of residents without extensive site clearance.

NIP operated under federal-provincial agreements permitting each province to select municipalities to

receive federal funds on the basis of criteria acceptable to CMHC. To be eligible for NIP, a neighborhood had to be predominantly residential and stable, with a significant portion of its housing stock in need of repair to comply with minimum standards; the residents had to be predominantly people with low to moderate incomes; and social and recreational amenities had to be inadequate. Given the low and moderate income eligibility criteria, the program objective also involved redistribution. As well, given that the program provided assistance to neighborhoods the objective was also one of alleviating the 'prisoners dilemma in maintenance' problem discussed in Chapter 2.

The Neighborhood Improvement Program had two components. Under Section 27.2 of the National Housing Act, CMHC contributed outright grants for 50 per cent of the cost of most types of expenditures in the program and 25 per cent of other types, which included principally the improvement of utility services. Total commitments under the grant section of the program were approximately $200 million. Under Section 27.5 of the NHA, CMHC made loans at the direct NHA lending rate to the municipality to cover 75 per cent of the municipality's contribution of the costs and to commercial enterprises for improvements to their properties (to a maximum loan amount of $10,000 in the latter case). Total loan commitments under the program were roughly $65 million.

No new commitments were accepted for the Neighborhood Improvement Program after March 31, 1978, but expenditures based on the previous grant commitments of $200 million including administrative costs to CMHC are expected to be approximately $100 million over the period 1979 to 1983. As of January 1, 1979 the Neighborhood Improvement Program and a number of other programs were replaced by the Community Services Program. This latter program is discussed in detail later in this Chapter.

Residential Rehabilitation Assistance Program

Part IV.1 of the National Housing Act established the Residential Rehabilitation Assistance Program (RRAP). Under this program, CMHC offers subsidized loans for certain types of repairs and improvements to existing houses. Those eligible are homeowners and landlords agreeing to rent controls in areas designated by CMHC; non-profit corporations and co-operatives in any area; and homeowners in communities of less than 2,500 people who are eligible under the Rural and Native Housing Program. Priority is given to repair of the building, upgrading insulation, and improvements to the plumbing, electrical, and heating systems. Non-profit organizations can receive funds to convert structures to higher density use.

Under RRAP, loans can be made for a maximum of $10,000 per dwelling unit of which up to $3,750 can be forgiven. A homeowner is eligible for the maximum 'forgiveness' if his adjusted family income is less than $6,000. For each $1,000 of additional income he loses $750 of 'forgiveness'. For each year the homeowner continues to occupy the house, $750 of his loan is forgiven until the forgivable portion is exhausted. Prior to 1978, homeowners with adjusted incomes below $11,000 also received an interest reducing grant to bring the effective interest rate down to 8 per cent.

Recent amendments to the NHA removed restrictions as to the neighborhoods and areas in which loans may be made. The amendments also provided for Residential Rehabilitation loans to be made by private lenders and insured under the NHA. In the case of a loan made by an approved lender, the forgiveable portion is provided through a fully forgiven loan from CMHC under Section 34.1 of the NHA.

Homeowner assistance remains unchanged, but landlord assistance was revised in 1978 to provide that 50 per cent of the cost of repairs may be forgiven to a maximum of $2,500. The maximum available forgiveness is $3,750 per unit for non-profit corporations.

Forgiveness is earned by the borrower over 5 years in the case of homeowner loans and 10 years in the case of rental loans. The unearned portion of the forgiveness becomes repayable if the landlord breaks the operating agreement in respect to rental rates or if the homeowner ceases to occupy the property.

The objectives of the program are much the same as the objectives of the Neighborhood Improvement Program discussed previously -- redistribution and alleviation of the prisoners dilemma in maintenance. Subsidies, however, are focussed toward individuals rather than municipalities.

If the program continues to operate under existing conditions, estimated expenditures for the period 1979-85 are expected to be roughly $135 million per annum.

Home Insulation Programs

Two federal programs were introduced during 1977 to provide financial assistance for the purchase of insulation materials for residential dwellings. In February, 1977, the Home Insulation Program (HIP) was instituted for Prince Edward Island and Nova Scotia, the two provinces thought to be most affected by rising energy costs. On September 1 of that year, the Canadian Home Insulation Program (CHIP) was introduced. CHIP applies to all areas of Canada except Prince Edward Island and Nova Scotia (which continue under HIP). Both CHIP and HIP are administered by CMHC.

CHIP has been directed initially at the older dwelling stock but is to be extended to newer dwellings as funds permit. Eligible residential housing includes units built before 1961 in all the provinces, and units built before September 1, 1977 in the Yukon and Northwest Territories. Residential housing units must be self-contained, principal residences; units must be located in buildings of less than 3 storeys; and all tenure types are eligible to apply (owners, landlords, tenants, etc.). The maximum grant under the program is $500. Grants are confined to the purchase of material

and labour and are taxable. HIP grants are much the same with the exception that they are non-taxable.

For the year 1978, expenditures under HIP and CHIP were $28.9 and $18.4 million respectively. It was expected that grants under HIP would reach their maximum by 1981, with estimated expenditures over the period 1979-81 to be roughly $30 million. CHIP was expected to have a longer life with expenditures estimated at $165 million per annum over the period 1979-85.

4.6 Land Acquisition and Municipal Infrastructure

This section first describes land assembly programs operated by CMHC until this year. Two other programs are then reviewed -- the Municipal Incentive Grant and the Municipal Infrastructure Program, which were both terminated by the end of 1978. The last remaining program, Community Services, is described at the end of this section. This program provides cash transfers to the provinces for distribution to municipalities for certain types of local public expenditures. The Community Services Program is currently active.

Land Assembly

Until 1979, CMHC was involved with the provinces in land assembly programs. Two approaches were utilized. Under Section 40 of the National Housing Act, land assembly costs were financed 75 per cent by the federal government and 25 per cent by the provinces with the investment being fully recovered from the disposal of lots to individuals or from the sale of block lands by public tender. Any profits remaining after cost recovery were then used to enhance the municipality where the assembly project was undertaken. Under Section 42 of the National Housing Act, the Corporation made a loan to the municipality or provincial agency to acquire land for general housing purposes. The interest rate charged by CMHC was the normal NHA direct lending rate. In both of these cases, CMHC acted in its role as a financial intermediary, although in the

case of Section 40 the investment is a direct investment in real estate. Over the past five years, approximately 20,000 lots have been produced via that program, with the net federal contribution in the form of loan or direct investment being close to $300 million. However, in response to recommendations made by the Federal/Provincial Task Force on the Supply and Price of Serviced Land, the program was disbanded in 1979.

One of the objectives the federal government pursued in commiting funds to public land assembly has been the reduction in land prices. The rationale for this initiative rested on the view that land developers were earning large speculative profits on their holdings and that those profits could be lessened if governments also marketed land holdings.

There is little evidence to support the notion that land developers are exercising market power in most urban regions and no comprehensive evidence that government land assembly projects have served to decrease land prices. Rates of increase in land prices in market areas with extensive public ownership have generally been the same as increases in markets having limited public ownership.

Public land assembly aid has also sought to encourage municipalities to improve their planning on the grounds that if they held land on a significant scale themselves, they would plan more effectively. However, municipalities must plan in any case. Improvements in the planning process might be as easily attained by focussing on the planning process directly.

Municipal Incentive Grant

The Municipal Incentive Grant was introduced in 1976 by Bill C-77. With this program, CMHC acted as a department and paid explicit subsidies of $1,000 for each eligible family housing unit for which a building permit was issued between November 1, 1975 and December 31, 1978. To be eligible, the development had to be

medium density, with moderately priced units. As such, the grant addressed itself to the problem of municipal fiscal deficits on this type of development with the explicit objective being to increase the supply of serviced residential land used to construct moderately priced dwelling units. Expenditures under this program were $40 million in 1978. Although the program expired at the end of 1978, decreasing expenditures are forecast until 1983 with total expenditures over the 1979-83 period estimated to be $55.9 million.

Municipal Infrastructure Program

Another program which was eliminated in 1978 was the Municipal Infrastructure Program. In terms of importance, this was one of the largest programs offered by CMHC with 1978 loan commitments of $290 million. The objective of the program was to lessen municipal resistance to development and thus increase the supply of serviced land. The program operated in two ways. Under Section 51, CMHC functioned in its financial intermediary role and made loans to provinces, municipalities, or municipal sewage corporations to finance trunk, storm, and sanitary sewers as well as water supply projects. Loans for up to two-thirds of the cost of a project were provided at the direct loan NHA interest rate.

Under Section 52 of the Act, CMHC operated as a department and provided subsidies in three ways. First, with respect to projects financed under Section 51, CMHC forgave payment by the borrower of 25 per cent of the principal amount of the loan and 25 per cent of the interest that had accrued from loan advances at the completion date of the project. Thus, the subsidy portion for municipal infrastructure projects financed under the NHA was roughly one-sixth of the cost of the project. Second, with respect to sewage treatment and water supply projects that were not financed under the NHA, CMHC provided a grant of approximately one-sixth of the total costs to the provincial or municipal agency involved. Finally, when the cost of a sewage treatment project imposed an excessive per capita

burden on local taxpayers, CMHC could make a maximum grant of 50 per cent of the capital cost of the project.

Although the program was discontinued in 1979, expenditures based on previous commitments are expected until 1983. Over the period 1979-83, subsidy expenditures through either loan forgiveness or grants including administration are estimated to be $226.1 million.

Community Services Program

In 1979, the federal and provincial governments have agreed to adopt a 'global' funding approach to federal financial aid to municipalities by consolidating the Neighborhood Improvement Program, the Municipal Infrastructure Program, and the Municipal Incentive Grant Program into one Community Services Program. Under this program, CMHC no longer acts as a financial intermediary but rather plays the role of a departmental agency offering explicit subsidies. In 1979, CMHC made grant commitments to the provinces of $150 million and as of January 1, 1980 the federal government will increase its long term funding to a level of $250 million per year. A number of community services including sewer plants and systems, water supply facilities, social and cultural facilities, neighborhood improvement, non-profit housing, upgrading of community facilities, facilities which convert waste to energy, and other services are eligible.

The objective of this program is much the same as that of the municipal infrastructure program which it replaced -- to reduce municipal disincentives to service residential land. Because funds are allocated on the basis of population and municipal tax capacity, a second objective of the program is one of redistribution. That is, the program attempts to provide assistance to those municipalities -- and consequently to households in them -- which are in greatest need, as well as reducing administrative costs

by disentangling the federal government from project by project scrutiny.

4.7 Other Major CMHC Programs and Activities

The previous five sections have focussed on the major activities undertaken by CMHC. Other activities conducted by CMHC include provision of assistance to specific developments such as Granville Island, providing policy advice to the federal cabinet, assistance to rural and native people, and funds for research activity. Two of these activities, Rural and Native Housing and research activity, will be discussed in this section. The others are not discussed because of their small size or relative uniqueness.

Research Activity

Under Part V of the National Housing Act, CMHC has the authority to carry out activities to promote the development of effective programs to deal with housing problems in Canada. The review of current programs, the development of new and innovative solutions to housing problems and the gathering, synthesis, and dissemination of information insofar as it relates to housing and housing conditions in Canada are the broad objectives of this activity. Estimated expenditures under this program are currently $23 million per annum. A number of activities are undertaken to meet these objectives, including demonstration projects conducted with private industry or independently using CMHC or federally-owned land; the development of measures to ensure construction efficiency and improve community planning techniques; the providing of information to the public in general; the providing of financial assistance to institutions involved in housing research; the providing of scholarships to graduate students undertaking research in urban and regional related subjects; and the providing of start up funds to community housing groups. Funds under Part V are also used internally to conduct policy-related research

to enable CMHC to plan its programs more effectively and to respond to changing housing conditions in Canada.

Rural and Native Housing Program

The Minister of State for Urban Affairs announced the Rural and Native Housing Program on March 7, 1974. The policy objectives of this program were both quantitative and qualitative and they were to be achieved largely through existing housing legislation.

The quantitative goal has been the production, acquisition, and rehabilitation of 50,000 units in rural communities of 2,500 or less over a 5-year period. In 1976 it became obvious that this objective could not be met and the time frame was extended to 1981. The qualitative objective of the program has been to encourage and facilitate client participation in helping to solve their own housing problems.

In accomplishing these objectives, CMHC has acted through the Rural and Native Housing program in most of its major capacities as insurer, financial intermediary, and administrator of grants and subsidies. This program has packaged together and somewhat modified existing program instruments, including Section 40 Home Ownership, Section 34.15 modified Home Ownership, Section 34.1 Residential Rehabilitation, and Section 36(g) Emergency Repair Program. In addition, there are a number of mechanisms used to support client participation such as project start up funds, sustaining grants, and training grants that are funded under Sections 36(g) and 37.1 under Part V of the NHA.

In its early years, the program, partly as a result of the cumbersome partnership arrangements required, was very slow in starting and as a result it generated considerable native criticism. The program is presently expected to reach the original target of 50,000 units within the next few months, although there is an unevenness between initial provincial targets and

actual achievements. This early achievement of the 1981 target is partially the result of the fact that residential rehabilitation, rather than new construction, has become the main vehicle for delivering improved housing conditions in rural areas. Estimated expenditures for these programs in the context of Rural and Native Housing are expected to be approximately $565 million over the period 1979-85.

4.8 Other Federal Housing Policies

While the majority of federal housing programs are operated by CMHC, some are also operated by other departments or through the tax system. The purpose of this section is to briefly discuss these programs.

Department of Veterans Affairs

The Department of Veterans Affairs provides assistance to help veterans to acquire houses. In general, the programs operated by Veterans Affairs provide additional subsidies on CMHC subsidized projects if 50 per cent of the tenants in a project are veterans or surviving spouses of veterans.

Department of National Defense

The Department of National Defense directly provides housing for military personnel at a rental cost comparable to that in the civilian community where rental accommodation is not available in the local community.

Department of Indian Affairs and Northern Development

The Department of Indian Affairs and Northern Development provides assistance to registered Indians. This consists of technical aid, counselling, and construction assistance, as well as financial assistance in the form of subsidies and CMHC

loans guaranteed by the Minister of Indian Affairs and Northern Development.

National Research Council

The National Research Council provides a research and technical information service to the Canadian construction industry in general and to government departments and agencies in particular. Emphasis is placed on carrying out research pertaining to the National Building Code, residential building standards, and the National Fire Code.

Department of Regional Economic Expansion

The Department of Regional Economic Expansion provides assistance in areas requiring special measures to improve opportunities for productive employment. While housing assistance is not a specific objective, aid may be provided to overcome a housing problem when housing is an important element in the attainment of a specific development opportunity and would not otherwise be made adequately available. Assistance for municipal infrastructure is also available.

Canada Assistance Plan

Substantial assistance is provided to lower income Canadians via the Canada Assistance Plan (CAP). Under CAP, general assistance is provided on a needs tested basis for requirements such as food, clothing, shelter, fuel, utilities, household supplies, and personal necessities. As well, special items deemed necessary for the safety, well-being, and rehabilitation of needy persons are covered. It is estimated that payments for shelter alone under CAP were $200 million in 1976.

Assistance under the Canada Assistance Plan is provided to persons considered to be medically or socially incapacitated for employment, including disabled persons, deserted wives with children, widows with

dependent children; and persons who, because of unemployment or under-employment, are unable to provide for basic necessities. CAP is primarily a program designed to offset short-term problems. For example, a significant proportion of social assistance case loads receive assistance for only a short period of time. Co-ordination between social assistance and housing assistance usually comes at the local level.

Programs Operated Through the Tax System

There are a number of programs operated through the tax system which have an important effect on the housing market. The most important of these are discussed below.

The Registered Homeownership Savings Plan (RHOSP) is a plan in which the federal government provides an incentive for households to save for purposes of purchasing a house. The plan incorporates two incentives. First, contributions are deductible from income, while proceeds are not taxable if used to purchase a dwelling unit. This results in a tax saving equal to the marginal tax rate multiplied by the level of contribution. Second, funds in a RHOSP earn tax free income while in the plan. The cost of the program was estimated to be roughly $85 million in 1976 with the major beneficiaries being middle and higher income households. The program has the effect of delaying or shifting forward the demand for owner-occupied housing and possibly increasing the total long run demand for homeownership.

Capital gains on owner-occupied units are exempt from capital gains taxation in Canada. Because most other capital gains are taxed at one-half of the rate for other types of income, the preferential tax treatment of capital gains from a principal residence increases the investment as opposed to the consumption aspect of homeownership and results in increased demand and an incentive to purchase a unit rather than rent. The major beneficiaries of this program are higher income groups because the proportion of owner households

increases with income, the value of the dwelling units and hence the magnitude of a capital gain generally increases with income, and higher income groups have higher marginal tax rates.

Capital cost allowance provisions exert a substantial impact on the housing sector. The new Canadian Income Tax Act, effective from January 1, 1972, eliminated the tax shelter aspect of capital cost allowances by preventing a taxpayer, other than a real estate corporation, from claiming capital cost allowances on rented property in excess of the income from the property. Previous to this Act, both corporate and personal investors in real estate could claim a capital cost allowance for buildings, exclusive of land, against income from <u>any</u> source, in addition to the allowable deductions from income such as property taxes and mortgage interest. From 1972, however, investors could only use the capital cost allowance to create a loss against rental income.

The second major change affecting CCA made in 1972 was discontinuation of the right to pool all rental buildings for tax purposes. The ability to pool rental buildings had meant that tax could be postponed on recaptured depreciation when a property was sold, if other properties with unallocated CCA existed in the pool or were purchased in the same fiscal year. This allowed for the deferral of tax payments and a corresponding improvement in cash flow. Discontinuation of pooling was effected by new regulations which placed each rental building worth $50,000 or more in a separate class. Recapture or terminal loss would thus occur on the sale of <u>each</u> property when pre-1972 pools were depleted and tax deferral was no longer possible.

These changes in the treatment of capital cost allowance substantially reduced the incentives for Canadians to own residential rental properties, and a substantial reduction in private investment in new rental units occurred after 1972. Consequently, toward the end of 1974, it was announced that the tax shelter aspect would be temporarily reintroduced for new

multiple dwelling residential construction begun prior to the end of 1975. The plan created a new taxation class, multiple unit residential buildings (MURB's) which qualified for this tax status upon issuance of a CMHC certificate. Since 1975, annual extensions have been given, extending the period of starting construction which qualifies to the end of 1979. The objective of the scheme was to stimulate private rental construction, but it has also introduced substantial distortions into the housing and capital markets.

The mortgage interest and property tax credit program announced on September 17, 1979 will have an important impact on housing. Under the program, a homeowner is entitled to a tax credit equal to 25 per cent of the first $5,000 of mortgage interest paid, to a maximum of $1,250 in 1982. As well, there is a property tax credit of $250 per home. Because this will be phased in over a period of four years, the 1979 tax credit on mortgage interest will have a maximum of $312.50 and a property tax credit of $62.50. It is estimated that the cost of this program will be $575 million in 1979.

A number of other provisions of the tax system such as the non-taxation of imputed rental income, the setting of CCA rates at other than true economic depreciation, and the non-deductibility of some carrying costs associated with land also affect housing and residential construction activity, but are not dealt with here because these tax policies have limited relevance to this enquiry.

5 FINANCIAL OPERATIONS OF CMHC

CMHC operates in a dual capacity: as a financial institution and as a government housing department. In its financial institution role, CMHC is engaged in borrowing and lending funds for various types of housing projects, and as a government insurer of mortgage loans made by private lenders. In its departmental role, CMHC activities are designed to implement the housing objectives of the government by administering federal grants, contributions, and subsidies for housing. Given these fundamentally different functions, CMHC's financial operations should be categorized and analyzed separately. However, since CMHC activities are not budgeted and costed separately, such an analysis must be based on limited information. This Chapter provides an analysis of CMHC's financial matters and attempts some imputation of costs to the various activities.

5.1 Financial Flows in Relation to Financial Role

CMHC activities which can be considered as essentially financial as opposed to primarily subsidy programs include the insurance function and the financial intermediary function in providing loans which otherwise might have been obtained from the private sector (so called 'residual lending').

NHA Insurance Operation

As an insurer, CMHC receives an origination fee of $35 per unit. This is intended to cover the cost of opening the file, appraisal, inspection, and underwriting. CMHC also receives an insurance premium which is generally around 1 per cent of the amount of the loan insured. It was intended that the origination fee would cover all the associated costs of originating the insurance, i.e., that there would be no subsidy in this fee. On the other hand, it was arranged that the insurance premium would be set aside to create a fund to cover the risk. This procedure has been followed

since 1954, with the insurance premium accumulating in insurance funds.

CMHC has responsibility for administering the assets of four funds: the Mortgage Insurance Fund (MIF), the Home Improvement Loan Insurance Fund, the Rental Guarantee Fund, and the Home Insulation Contribution Fund. As indicated in Table 5.1.1, total assets of these funds as at December 31, 1978 amounted to $672.9 million, of which the MIF accounted for $631.6 million. Against these assets were contingent liabilities of approximately $21.3 billion. Since the MIF dominates these activities, our comments will be confined to just this fund. Because of the nature and evolution of the insurance program, three major financial problems with the MIF have evolved because of the fee structure, the allocation of costs and fees, and portfolio composition changes in the MIF.

(i) Fee Structure

As described above, CMHC charges an origination fee of $35 per dwelling. Although it was intended that the fee would cover all the associated costs of originating the insurance, the actual related costs have considerably exceeded the revenues generated from the origination fee. This occurs since the $35 fee has remained unchanged from its inception and the true costs appear at this time to range from $40 per unit for large multiple unit projects to $300 per unit for single family units. Given the current volume of dwelling units insured, it is estimated that the Corporation will lose approximately $15 million on this activity in 1979. Consequently, the Corporation is providing a subsidy to borrowers on all its insurance, whether or not subsidies for such borrowers could be justified on any grounds described in Chapter 2.

NHA borrowers also pay a fee in the form of an insurance premium that is generally one per cent of the value of the mortgage loan, and this goes directly into the Mortgage Insurance Fund. This premium is approximately the same over the whole range of CMHC insured loans with only a minor distinction made

Table 5.1.1

Insurance and Other Funds and Insurance in Force
Administered by CMHC as at December 31, 1978
($ millions)

Fund	Reserves	Insurance in Force
Mortgage Insurance Fund	$631.6	21,317.8
Home Improvement Loan Insurance Fund	4.9	25.3
Rental Guarantee Fund	10.1	0.0
Home Insulation Fund	26.2	--
Total	$672.9	

Source: CMHC Annual Report, 1978

between rental and ownership loans. However, there are many classes of loans that present different degrees of risk and which, if not covered with appropriate insurance premiums, are actuarily unsound. The consequences of this are that CMHC, partly in pursuit of its social objectives, will be presented with a disproportionate number of high risk loans, such as graduated payment MURB loans, which increases its exposure substantially, possibly to the point where potential losses in this category could jeopardize its overall portfolio. Thus, large uncovered contingencies are arising from this procedure.

(ii) Allocation of Costs and Fees

CMHC insurance premiums go directly into the MIF but the origination fees enter into CMHC's operating revenues. Origination costs, on the other hand, are taken out of the operating budget. However, since these origination costs considerably exceed the fees paid, CMHC incurs an operating loss from its mortgage insurance operations which is not explicitly reflected in its insurance operations. In addition, until the late 1960's, the CMHC operating budget bore the expense of administering the claims against the MIF and the resulting real estate administration costs. Since then, the MIF has reimbursed the operating budget of CMHC for costs related to administering claims against the fund.

As a consequence of this legislated arrangement, the MIF has grown steadily from accumulated insurance premiums, as well as accumulated earnings on its investment, while the operating budget of CMHC has absorbed significant losses associated with initiating loan insurance and administering the MIF. The overall effect of this is that the true costs of NHA insurance are not apparent and CMHC has no check to ascertain its efficiency and the appropriateness of its various charges. This is likely to lead to inappropriate financial practise and inefficient operation.

(iii) Portfolio Composition Changes in the MIF

As Table 5.1.2 indicates, the various asset components in the MIF have changed considerably in the last few years. Prior to 1979, securities were the overwhelmingly largest single asset item. However, in 1979, as a consequence of insuring inappropriate loans (and charging too low an insurance fee for these loans, if they were to be insured), a large volume of defaults arose, primarily associated with subsidized forms of housing loans. These defaults lead to a rapid increase in real estate holdings and in mortgages taken back on property sold. The overall effect has been to substantially reduce the liquidity of the MIF, and to significantly increase its vulnerability to future claims. If the rate of liquidity loss of the past year were to continue, the very real possibility exists that the MIF will not have sufficient liquidity to meet claims upon it by early in 1980.

Further compounding the problem has been the failure of the MIF to dispose of real estate and mortgages quickly enough. If such disposition were to occur, the liquidity of the fund would improve, although the fund might experience some additional capital losses.

The change in the portfolio composition has had an impact on the fund in other ways as well. The properties taken back have resulted in a significant loss to the fund since they are held on the books of the fund at market value whereas the value of the claim paid to the lender is for the higher 'book value', i.e., the amount of the claim plus legal expenses. As well, the fund has suffered a capital loss through the sale of securities during the past year because of the high interest rate structure during this period of time. Indeed, the loss to the fund on real estate taken back in 1978 amounted to $57.6 million and the capital loss on securities sold during the same period was $1.4 million. As well, the fund incurred additional costs of $8.8 million in disposing of such accumulated real estate.

When the losses implied in the portfolio composition change are added to those associated with inappropriate

Table 5.1.2

Mortgage Insurance Fund
1973-78
($ thousands)

Assets	1973	1974	1975	1976	1977	1978	1979 (July 31)
Cash and due	2,661	1,823	4,176	2,224	6,583	2,449	1,000
Securities	246,051	276,567	316,750	377,895	434,315	362,690	175,000
Mortgages	78,160	96,214	96,277	98,281	101,226	114,008	132,000
Real Estate	51,042	40,990	42,083	43,443	70,965	152,444	323,000
Total	377,914	415,594	459,286	521,848	605,925	631,591	631,000

Source: CMHC Annual Report

fee structures and operating inefficiencies, it is clear the overall loss of CMHC's insurance operations is substantial.

Financial Intermediary Operation

In its financial intermediary role, CMHC obtains funds from which it makes advances through capital budget allocations approved from the federal government. These budgetary allocations are recommended by the Minister Responsible for CMHC, the Minister of Finance, and the President of the Treasury Board for approval by the Governor-in-Council. Once approved, they become the authority by which CMHC can make commitments for selected projects. Of course, in performing this function, CMHC incurs administrative costs which are not allowed for in its capital appropriation. Also, most intermediary activities represent both financial and social functions since CMHC advances funds for projects which either could not obtain private financing or could not obtain financing on the terms provided by CMHC. Since CMHC funding is also obtained relatively cheaply for the type of loan being made, the implicit interest subsidy cost is passed back to the Government of Canada. The administrative costs, on the other hand, remain with CMHC.

The magnitude of the above lending function and the corresponding authorizations under the National Housing Act have risen steadily to $1,819.0 million in 1977 and then declined to $495.3 million in 1979, as a consequence of changing federal government desire to undertake such programs. Because repayments on loans now exceed new advances, the dollar value of assets under CMHC administration is beginning to decline. These assets are currently about $10 billion.

The financial intermediary activities of CMHC imply an interest margin for the Corporation which is similar to the intermediation spread of trust and mortgage loan companies (typically regarded as the difference between the 5 year commercial mortgage rate and the 5 year GIC rate). This interest margin was 3/8 of 1 per cent for most but not all CMHC lending from the late 1960's

to 1978, and has been the chief source of operating revenue for the Corporation.

The appropriateness of the 3/8 of 1 per cent spread became increasingly difficult to justify in the light of increasing operating costs and the generally higher spread expected by private financial lenders. On the other hand, the Corporation has virtually no administrative costs associated with its source of funds in contrast to private institutions where capital acquisition represents a major cost. CMHC also has some very large loans which reduces the average cost per dollar invested. In 1978, however, as a matter of government policy, CMHC's direct lending rates were set at market rates except where prevented by legislation. Prior to 1975, the Corporation was, in some cases, required to lend at less than its borrowing rate. These losses are now reimbursed through budgetary appropriations.

CMHC intermediary lending occurs for a wide variety of reasons; the programs utilizing this lending for the past 5 years are set out in Table 5.1.3. This table indicates a substantial shift in the nature of CMHC lending during this period, with 'social housing' loans rising from 38 per cent to 50 per cent of loans, land assembly and municipal infrastructure loans rising from 13 per cent to 24 per cent of all loans, and community revitalization loans rising from 0.6 per cent to 9.9 per cent of all loans, while market housing loans declined from 46 per cent to 9 per cent of all loans. The pattern of capital lending shown in this table lags behind the authorizations described above because of the lag from the commitment to the undertaking stage. However, the general decreasing trend of the Corporation's gross capital advances can be seen in the projections of Table 5.1.4.

Although CMHC has generated an overall operating surplus on its lending activities during the past 34 years of its existence, the Corporation is now facing an impending operating deficiency. This deficiency is likely to arise for the following reasons:

Table 5.1.3

Gross Capital Advances by CMHC, 1974-78
($ millions)

Program	Calendar Year				
	1974	1975	1976	1977	1978
Public Housing					
Loans	179.1	233.8	257.7	243.1	195.0
Federal-Provincial Investments	37.2	70.8	100.4	103.8	44.8
Non-Profit Corporations	145.7	211.2	358.3	272.9	202.1
Cooperatives	11.7	15.5	48.6	40.9	52.1
Rural and Native Housing	*	*	*	*	76.6
Direct Loans	436.9	443.9	206.0	72.3	29.3
Assisted Home Ownership Program	-	-	2.3	22.3	37.5
Assisted Rental Program	-	-	-	7.4	37.8
Student Housing	7.0	7.1	2.9	.4	6.2
Land Assembly					
Loans	15.8	57.5	40.7	34.8	19.5
Federal-Provincial Investments	11.0	28.1	16.5	13.6	18.9
Sewage and Water Treatment	101.9	124.2	185.0	165.9	240.3
Neighbourhood Improvement	.1	.8	1.0	2.3	4.1
Residential Rehabilitation	.7	10.6	37.4	84.1	107.2
Urban Renewal	4.6	2.1	3.1	1.1	1.4
Real Estate Sales	-	-	-	11.2	45.4
Direct Acquisition	11.4	11.9	15.9	14.0	15.4
Total	965.1	1,217.5	1,275.8	1,090.1	1,133.6

Note: * Included in Public Housing Federal-Provincial Investments

Source: CMHC

Table 5.1.4

Projected Gross Capital Advances by CMHC,
1978/79 to 1984/85
($ millions)

Program	Fiscal Year 1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Public Housing	333.5	326.6	228.6	199.5	149.2	157.3	149.5
Non-Profit and Co-op Housing	241.8	145.3	78.4	47.2	52.9	57.7	54.4
Rehabilitation	55.7	48.2	48.0	43.8	71.9	85.7	83.2
Sub-Total	631.0	520.1	355.0	290.5	274.0	300.7	287.1
Other	489.8	408.1	371.2	273.7	147.7	102.9	-- *
Total	1,120.8	928.2	726.2	564.2	421.7	403.6	--

Note: * Not available

(i) Administrative Cost Increases

In the recent past, administrative costs per dollar invested have been increasing since the outstanding loan balances of CMHC loans have been decreasing.

(ii) Aging Mortgage Portfolio

It is the nature of mortgage loans that during the early life of the mortgage, the bulk of the payment is allocated to interest amortization with very little credited to the retirement of principal; this situation is reversed toward the final years of the mortgage. Inasmuch as CMHC's interest margin is calculated on the outstanding balance of the mortgage loan, it follows that the margin earned by the Corporation will be relatively high during the early life of the loan and relatively low toward the end. Since the mortgage portfolio has been aging, CMHC now finds itself with a large volume of very mature mortgages on which the income generated is relatively small.

(iii) Non-reinvestment of Accumulated Surplus

Through the period of high interest income, surplus earnings were returned to the Receiver General by CMHC since it was precluded from accumulating reserves in excess of $5 million. As a result, CMHC did not have these funds to reinvest to generate revenues to compensate for the increasing costs and reduced earning associated with an aging mortgage portfolio.

The conclusion of a declining average outstanding loan balance and reduced interest margin as the CMHC loan portfolio ages implies that at some point the costs required to administer the mortgage portfolio will overtake the revenues generated from the portfolio and create losses on the outstanding loan portfolio. This problem was compounded by the limits imposed upon the size of surplus that could be accumulated by CMHC and by the decline in the growth of CMHC's loan portfolio.

(iv) Application Fee

Analogous to its insurance origination fees, CMHC charges a loan application fee of $35 per unit for direct loans on market type housing loans. This $35 fee is insufficient to compensate CMHC for putting the loan in place, and thus CMHC is providing a subsidy via insufficient fees on these market type loans. Moreover, CMHC does not charge any fee for its non-market loans, increasing the subsidy associated with this lending.

(v) Loss Incurred at Government Request

At various times the government has instructed CMHC to grant mortgage loans at such low rates as to not even cover the Corporation's borrowing costs from the Department of Finance, nor its administrative costs associated with the loan. These losses have been in the order of $20 million per year. In recent years, the government agreed to reimburse the Corporation for such losses in the form of annual compensation payments.

(vi) Bad Loans

Over the years, CMHC has made uninsured mortgage loans which embody higher risks than other institutions would have undertaken. These loans have been made as part of their social function and have resulted in the Corporation acquiring real estate holdings.

These real estate acquisitions have increased CMHC administrative costs and also resulted in incurring capital losses. Recently, such acquisitions have been increasing as a result of the increase in CMHC social lending during the 1970's.

The total real estate holdings arising from defaults in the mortgage portfolio and from foreclosured properties in the Mortgage Insurance Fund are presently approximately 28,000 units, and are expected to be at least 40,000 units by June 30, 1980. The magnitude of these holding is shocking, and the growth rate even

more startling. Finally, CMHC sales of such properties under their present administrative procedures have been only 1,200 units in 1977, 6,300 in 1978, and 4,500 to date in 1979, contributing to the growth in real estate holdings.

These figures have grave implications for the future financial operation of CMHC, since foreclosures directly involve losses for CMHC via below book value recoveries; rising administrative costs from managing a rapidly growing real estate portfolio; reduced earning assets (mortgages in default generate no revenues); and inefficiencies associated with conducting the inappropriate function of property management.

From the foregoing discussion it is clear that CMHC is moving into a period of sharply reduced net revenues and likely substantial losses through its financial intermediary activities. Some of these losses are the inevitable consequence of an aging loan portfolio which generates reduced earnings from a given yield spread as outstanding mortgage balances decline, and increased costs as the average loan size decreases during an inflationary period. However, the losses are also attributable to initiating high risk loans without a corresponding interest risk premium and to charging an inappropriate application fee for mortgage loans. Even if CMHC lending practices are altered, the mortgage aging process makes it inevitable that future losses will occur, but, if the practice of making social loans without an appropriate risk premium is continued, the losses are likely to be considerably greater.

5.2 Financial Flows in Relation to Departmental Role

CMHC performs many functions that could be considered to be departmental in nature. In this role, it is primarily financed by budgetary appropriations voted by Parliament, interest earned, and miscellaneous revenues. During the last 5 years, its budgetary expenditures have grown rapidly, from $149.6 million in 1974 to $694.1 million in 1978 and $851.2 million in 1979. The absolute importance of these expenditures is

set out in Table 5.2.1. The amount of these funds and the expenditures in these areas underestimate the true costs of CMHC's social functions. The underestimate occurs because of the following:

(i) some of the losses incurred in its intermediary functions are the result of socially inspired lending at inappropriate rates;

(ii) real estate owned by CMHC is often rented at below market levels thus generating implicit losses for CMHC, although some of these losses are compensated for through annual compensation payments to the Corporation;

(iii) the administration by CMHC of its real estate operations is not directly compensated for by the government;

(iv) the administration by CMHC of the subsidy, grants and contributions for public housing, urban renewal, privately funded sewage treatment loans, and rural and native housing program is not directly compensated for by the government;

(v) some of the policy, research, development, and statistical survey costs are not compensated for by the government.

Consequently, the social costs of federal housing programs exceed those explicitly indicated, and this underestimate of costs tends to increase the size of these programs. Notwithstanding these underestimates, the direct costs of these social programs are expected to rise to $1.4 billion in 1984-85, as shown in Table 5.2.2.

Table 5.2.1

CMHC Grants, Contributions, and Subsidies, 1974-78
($ millions)

Program	Calendar Year				
	1974	1975	1976	1977	1978
Public Housing	63.4	87.0	117.2	141.1	179.0
Non-Profit Housing	6.4	11.4	17.1	24.6	20.7
Cooperative Housing	--	1.8	3.9	5.4	6.2
Rural & Native Housing	5.7	5.9	6.6	4.3	6.2
Assisted Home Ownership Program	5.0	10.1	21.7	29.3	34.8
Assisted Rental Program	--	0.2	2.6	9.9	17.7
Land Assembly & Leasing	--	--	--	0.1	0.5
Sewage & Water Loan Forgiveness	25.7	31.3	51.2	78.6	105.2
Municipal Incentive Grants	--	--	2.1	36.3	45.8
New Communities	0.1	0.1	0.1	0.1	0.1
Neighbourhood Improvement Grants	2.7	6.3	12.5	21.7	32.3
Residential Rehabilitation Grants	1.2	10.2	28.7	62.9	88.3
Urban Renewal Grants	13.5	10.1	6.7	7.5	8.3
Discount on Sale of NHA Mortgages	--	--	--	--	38.1
Home Insulation Grants	--	--	--	43.4	47.3
Real Estate Operating Losses	5.8	9.6	10.3	11.3	13.7
Interest Rate Losses	4.1	8.5	11.6	27.2	25.9
Other	16.0	53.7	20.2	20.4	24.0
Total	149.6	246.2	312.5	523.8	694.1

Table 5.2.2

Projected CMHC Grants, Contributions, and Subsidies
1978/79 to 1984/85
($ millions)

	Fiscal Year						
Program	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85
Housing Research & Community Planning	$ 15.4	$ 23.4	$ 23.4	$ 25.7	$ 28.2	$ 31.0	$ 33.8
Public Housing	201.4	258.7	284.7	327.9	366.5	403.0	439.9
Non-Profit & Co-op Housing	0.4	5.1	28.0	73.4	123.1	176.7	232.8
Rehabilitation	100.0	118.9	127.3	135.3	140.8	143.4	145.1
Home Insulation	22.3	47.3	67.7	69.2	72.5	74.2	78.0
Community Services	--	--	154.8	250.5	250.6	250.6	250.6
Sub-Total	399.5	453.1	685.9	882.0	981.7	1078.9	1180.2
Other	449.5	395.7	293.6	217.2	167.0	167.4	203.5
Total	789.0	848.8	979.5	1099.2	1148.7	1246.3	1383.7

6 OPTIONS

This Chapter deals with alternatives to the structure of Corporate activities and the manner in which those activities are carried out. The Task Force considered that any alternative should address two major questions: first, the serious financial problems facing the Corporation and, second, the appropriate activities to be undertaken by the federal government in light of housing market conditions in the next decade. The alternatives considered ranged from the two extremes of maintaining the current operations and array of programs to a major revision of CMHC's role in housing. A range of intermediary options to rationalize CMHC activities was also considered. Each corporate activity was analyzed independently for its contribution to the financial problems facing the Corporation and its effectiveness in satisfying housing needs in the 1980's.

In considering each of these alternatives, the Task Force found that certain factors were important in assessing the desirability of privatizing the various functions presently performed by CMHC, and for selecting the best privatization option in the event privatization is warranted. The Task Force considered that the effects on the following were among the appropriate criteria to be used to assess the merits of privatization:

(i) resource allocation throughout the economy;

(ii) the cost effectiveness in providing goods and services to the economy;

(iii) economic stability;

(iv) the conduct of social policy; and

(v) Canadian control of real resources.

An elaboration of these criteria is found in the Appendix.

The above criteria are all appropriate for considering the desirability of privatizing different CMHC activities. It should be noted, however, that these criteria do not equally apply to all CMHC activities. Consequently, an objective assessment of their relative importance was made in reviewing each of the options.

6.1 Status Quo

The Task Force considered the option of leaving unaltered the existing array of CMHC activities and programs and only introducing improved financial arrangements to increase the efficiency and cost-effectiveness of each activity.

The advantages of this option are that:

(i) It is administratively easy;

(ii) Financial changes could eliminate the losses associated with the insufficient NHA insurance initiation fee and might be able to reduce losses associated with inappropriate fees on some classes of insurance;

(iii) Procedural changes could expedite real estate sales, thereby reducing management costs and the degree of illiquidity in the MIF; and

(iv) The financial operations could remain integrated with the subsidy operations in conducting social policy.

The disadvantages of this option are numerous. The general disadvantages include the following:

(i) Mixing social and financial functions blurs and distorts the costs of each;

(ii) The cost-effectiveness of each activity is impaired.

Disadvantages related to specific CMHC activities follow.

With respect to NHA insurance activity:

(iii) The insurance program serves social as well as financial purposes, and the hidden subsidies implicit in this would likely continue;

(iv) Government would continue to conduct a function which appears unnecessary given the evolution of the Canadian capital market;

(v) Losses are likely to arise through the continued insuring of high risk loans at an inappropriate insurance fee;

(vi) CMHC would likely continue to acquire undersirable real estate through its insurance operation;

(vii) The MIF is likely to remain illiquid and possibly become more so because of the difficulty inherent in government efficiently disposing of real assets; and

(viii) Losses associated with the illiquidity of the MIF are likely to be incurred.

With respect to the CMHC mortgage portfolio:

(ix) Government would continue to conduct an activity which is not necessary for the government to conduct;

(x) CMHC is likely to incur losses in the future from the management of the portfolio because of the aging process of the portfolio without corresponding economies in management;

(xi) CMHC will continue to acquire undersirable real estate in the event of default on its mortgage loans;

(xii) In the event of mortgage defaults, CMHC would be involved in the management of its real estate holdings and the disposition of these holdings, functions for which it is not suited.

With respect to real estate holdings:

(xiii) CMHC would be saddled with the on-going management of a real estate portfolio it is not suited to handle;

(xiv) CMHC would be charged with the responsibility of disposing of its real estate holdings, an activity inappropriate for government;

(xv) Continued large scale CMHC ownership could easily introduce distortions into local real estate markets;

(xvi) The real estate function could easily be combined with the social functions without explicit recognition;

(xvii) The costs associated with the operation, management and disposition of the real estate are likely to exceed those incurred in the private sector;

(xviii) The speed of asset disposition is likely to be slower, increasing the costs associated with the real estate holdings and impeding the liquidity of the MIF.

With respect to social or departmental activities:

(xix) CMHC would continue to operate programs not meeting the appropriate target groups, such as the co-operative and non-profit housing programs and some parts of the rehabilitation program;

(xx) CMHC would be involved in duplication of activities with the provinces;

(xxi) Programs would continue in which the decision making and managing body has little financial obligation for the consequences, while the federal government would remain financially responsible for programs which it does not control, such as the management of public housing;

(xxii) Assistance would continue to be provided to municipalities for programs that may not be necessary, such as in the community services program;

(xxiii) Provinces could continue to receive assistance to compensate for their own inappropriate programs, such as rent control; and

(xxiv) The cost of delivering housing benefits would not be minimized.

6.2 Options for Financial Functions

Options were analyzed for the following financial functions: mortgage insurance, mortgage re-insurance, non-departmental lending, mortgage management, and real estate management.

Mortgage Insurance

The Task Force considered two alternative methods in which CMHC could discontinue its mortgage insurance function. Both methods, which are set out below, involve the termination of new insurance underwriting by CMHC and the privatization of the management of the MIF and insurance portfolio. One method, however, involves the divesting of existing MIF assets and insurance liabilities while the other provides for government retention of these assets and liabilities.

In both alternatives a federal role of re-insurance is envisaged.

The <u>advantages</u> of terminating CMHC insurance underwriting are that it would:

(i) Relieve the government of an operation which is judged to no longer be essential for public policy purposes and one which is expected to incur substantial losses in the future if present operations and procedures were to be continued;

(ii) Prevent the insurance operation from being used for departmental or social functions, with the implicit subsidy this involves (i.e., in the form of a non-market fee structure); and

(iii) Prevent CMHC from acquiring future contingent liabilities;

The <u>disadvantages</u> of terminating CMHC insurance underwriting are that it would:

(i) Increase the cost to those who would have obtained NHA insurance because the hidden subsidy would be eliminated in the initiation fee;

(ii) Create the possibility of insufficient competition in the mortgage insurance industry since the termination of CMHC underwriting removes an impediment to collusion among the private insurers;

(iii) Create the possibility that high risk groups may not be able to obtain mortgages;

(iv) Reduce the attractiveness of Canadian mortgage investments for offshore investors; and

(v) Reduce the leverage which the federal government has for imposing construction and site standards for residential property.

For these reasons, ways were examined to encourage a private company to take up the room left unoccupied by CMHC withdrawal, to institute a federal re-insurance program, and to maintain the current level of investment in mortgages by banks. With respect to the latter point, the current Bank Act limits the investment in privately insured mortgages by chartered banks to 10 per cent of their Canadian dollar deposits. If this limitation is not adjusted once NHA insurance is discontinued, the effective level of investment in mortgages by banks will decrease.

The first method for resolving some of these disadvantages involves the creation of a new company initially to be wholly owned by CMHC that would take over the assets and liabilities of the MIF from CMHC. The company would be sold to the public as soon as possible, but hopefully within a year of its creation. CMHC would thus terminate its mortgage insurance underwriting, and management of the insurance assets and liabilities. The new private company would continue underwriting insurance for its own accounts and would manage the remaining MIF liabilities.

An alternative method for resolving some of these disadvantages involves CMHC agreeing to terminate writing mortgage insurance as of some date, possibly December 31, 1980, and arranging for the private management of its MIF and insurance portfolio. CMHC would retain the ownership and policy control of the assets and contingent insurance obligations of the MIF. A variant of this is that part of the consideration for obtaining the management would be that the private corporation enter the mortgage insurance field and commence underwriting insurance when CMHC activity ceases.

Under the first method, CMHC completely terminates its insurance operation (except for contingency re-insurance). The <u>advantages</u> of this compared to the second method are that it would:

(i) Generate government revenue on the sale of the fund and its contingent insurance liabilities;

(ii) Create a new on-going viable private entity in the mortgage insurance field, which would increase competition in the industry;

(iii) Provide direct employment for some existing CMHC staff;

(iv) Ensure that CMHC would not acquire additional real estate through the insurance operation;

(v) Eliminate the need for CMHC to give policy direction to the private manager of its existing fund.

The disadvantages of this method are the advantages of method two.

Under the second method, CMHC would retain the ownership and policy control of the assets and contingent liabilities of the MIF. The advantages of this compared to the first method are that it would:

(i) Enable CMHC to control the operation of the existing MIF;

(ii) Release CMHC from the operation and management responsibilities of the contingent liabilities and foreclosed real estate;

(iii) Ultimately enable CMHC to realize a larger net gain if the net present value of the assets over liabilities incurred, as the insurance lapses, exceeds the obtainable current market price for the assets of the fund and its contingent liabilities.

The disadvantages of this method are the advantages of method one.

Introduction of Contingent Re-Insurance Program

A contingent re-insurance program could be undertaken through an expansion of the mandate of the Canada

Deposit Insurance Corporation, or through CMHC. It could be administered like the Canada Deposit Insurance Corporation fund so that the gain or loss to the government is known. The program would involve the offering of re-insurance to private insurers and could be done in a variety of ways including acquiring full insurance in some classes of property, acquiring a proportion of the insurance with the private underwriting company, or re-insuring private loans for a temporary period until the loans are seasoned. It would be realized that under a re-insurance program the government would not be guaranteeing loans but would be participating in the losses of private mortgage insurers, subject to specified maximum limits. Under extreme conditions, however, private mortgage insurers might become insolvent and unable to pay their share of the claims.

The advantages of such a re-insurance program are that it could:

(i) Be used to reduce the shock to the capital market of the cessation of NHA insurance;

(ii) Raise the security provided by private mortgage insurance to a level that is somewhat between that currently provided by private mortgage insurance and by NHA mortgage insurance;

(iii) Increase the credibility of private mortgage insurance because of the association of the government;

(iv) Lead to some reduction in capital requirements for private mortgage insurers and so improve expected return on equity and also increase capacity marginally; and

(v) Enable private mortgage insurers to withstand a higher level of claims than at present.

The program could also be used to:

(vi) Encourage the introduction of new mortgage forms, such as Graduated Payment Mortgages, by insuring the excess loan balance under this scheme; and

(vii) Affect the cyclical availability of mortgage funds by altering the conditions for re-insurance.

The disadvantages of this program are that it creates the risks that:

(i) Government will become heavily involved in mortgage insurance underwriting through the back door; and

(ii) The re-insurance program might be used as a departmental tool.

Non-Departmental Mortgage Lending

Since CMHC has substantially curtailed non-departmental mortgage lending, i.e., acting in its intermediary role for non-social reasons, we do not provide any extensive analysis of the options in this area.

Mortgage Portfolio

The Task Force considered the options for handling CMHC's existing mortgage portfolio on the assumption that the cessation of new non-departmental lending would continue. The options included the possibility of CMHC:

(i) Retaining the ownership of its mortgage portfolio and contracting out the management; or

(ii) Disposing of the ownership and management of its mortgage portfolio.

The relative merits of these options are discussed separately for the privatization of management and the disposition of the existing mortgage portfolio.

The privatization of management option envisions CMHC turning the management of its existing mortgage portfolio over to one or more private entities for management. This could be done in a variety of ways either in conjunction with or separate from a disposition of the ownership of its portfolio (which is discussed below). If this option were selected an array of disposition alternatives could easily be found.

Advantages associated with the privatization of management are that it would:

(i) Relieve the government of an unnecessary activity which provides no net advantages and which, if present procedures are continued, is likely to involve a financial loss around the end of the 1980's;

(ii) Enable the portfolio to be managed efficiently and in a cost effective manner; and

(iii) Enable an efficient disposition of real estate obtained through default on existing loans.

One disadvantage to the privatization of management option is that the cost of administering subsidies attached to existing mortgages may increase slightly.

The second option envisions the disposition of CMHC's existing mortgage portfolio to the private sector. Such a disposition could occur in numerous ways and if this option were selected, the alternatives could easily be determined. One variant of this disposition procedure would be to offer the existing mortgagees the first option on acquiring the mortgages.

The advantages of disposition of the existing CMHC mortgage portfolio as distinct from the management are that it would:

(i) Raise considerable cash for the government;

(ii) Relieve government of the possibility of acquiring via mortgage defaults more real estate which is costly to manage and difficult for government to dispose of; and

(iii) Eliminate the need for CMHC to oversee and give direction to the private mortgage managers.

An apparent disadvantage of disposition of the mortgages is that it might result in the realization of a 2.5 to 4 billion dollar capital loss for the federal government. This, however, would be the realization of losses currently existing in the mortgage portfolio as a consequence of rising market interest rates and the possibility of bad mortgage loans. These losses have already been incurred and the realization of them is not the creation of a loss. For example, the funds raised could be used to redeem existing government debt at a substantial discount from book value. Alternatively, the large cash flows generated by a sale would reduce government current cash requirements (the interest saved being the current analogue of the realized capital loss); and interest on debt taken back would offset interest costs associated with existing or future government debt.

The disposition of such a large portfolio might impose a strain on the capital market in Canada. On the other hand, much of this potential strain could be offset by acquiring debt, or taking back outstanding government securities as partial payment. Finally, the timing of the disposition could be used as an anti-cyclical stabilization tool.

Real Estate Portfolio

CMHC presently owns and manages substantial amounts of real estate in its own portfolio and in the portfolio of the Mortgage Insurance Fund. The Task Force considered the options for handling CMHC's existing real estate portfolio on the assumption that it is

inappropriate for CMHC to be the direct owner of large real estate holdings.

Consequently, one option is for management of the real estate portfolio to be turned over to the private sector on a decentralized basis and for these managers to conduct an aggressive campaign to sell these assets under the direction of a person to head this sales campaign.

The advantages of utilizing the private sector to conduct the sale of real estate holdings and to provide local management pending such sales are that it would:

(i) Relieve government of an unnecessary management operation for which it is not suited and in which it incurs considerable expense;

(ii) Eliminate the pressure on government to provide hidden subsidies by renting property at below market rates;

(iii) Maximize the ultimate return on the portfolio by substantially increasing the speed at which CMHC disposes of assets, and by improving the marketability of the units by up-grading their condition and fully renting the buildings at market rents;

(iv) Enable a faster restoration of liquidity for the Mortgage Insurance Fund than under existing procedures; and

(v) Be a cost-efficient way of handling and disposing of the real estate portfolio.

No major disadvantages to this option are apparent.

6.3 Options for Departmental Function

In terms of a broad policy direction for social housing, increased flexibility to target housing programs to those in greatest need was considered to

be important. There is a significant number of Canadians with incomes too low to enable them access to sound basic housing at a socially acceptable housing expenditure to income ratio. Given the decreasing requirement for new house construction in the 1980's, the opportunity now exists for governments to adopt a strategy that emphasizes decreased shelter expenses for low income households and increased use of existing units. In both urban and rural areas, there is scope for improving low quality housing by renovating and upgrading the existing housing stock. In many instances, the cost of maintaining an existing unit in good condition may be less than constructing a new unit. In this regard, it seems appropriate that the federal government seek to package and target subsidy funds in a way that provides low income Canadians more direct and affordable access to existing housing accommodation that is in good repair.

The following discussion of alternatives should not be taken as a suggestion that the federal government withdraw assistance from those people in need, but that it move in favour of programs that pinpoint need and deliver assistance efficiently. The Corporation would need the legislation to implement such programs.

Public Housing

The Task Force considered ways to modify federal involvement under current programs excluding rent supplements on privately owned buildings and Rural and Native Housing. The federal government could negotiate with the provinces with the view to withdrawing from the joint long term subsidy commitments. All subsidy commitments involved in units under management which arose from the operation of the federal-provincial joint loan and federal loan programs would be honoured in a different form. This could be done in a variety of ways; for example, in the joint investment projects, the federal government could give up its equity interest, and in federal loan projects, the federal government could forgive the loans. No new capital and

subsidy commitments under the joint investment public housing program (Section 40 of the NHA) would be undertaken.

The advantages of this withdrawal are that it would:

(i) Disentangle federal and provincial roles and responsibilities in social housing; and

(ii) Provide an incentive for more prudent management of subsidy costs because the funds would be raised by the administering level of government. This would make management more cost effective and would improve the allocation of resources.

The disadvantages of this withdrawal are that:

(i) If the provincial governments do not maintain the same level of subsidy to the existing clients this could cause severe dislocations to the client group. This would affect female-headed single parent families and senior citizens the most; and

(ii) If the lost operating subsidies exceed the interest savings and managed economies associated with the transfers, the final costs to the provinces will increase.

Non-Profit and Co-operative Programs

The Task Force considered withdrawing federal funding, with the thought of developing a more efficient delivery system for benefits to low income households. The objective would be to design a program where need targets were more specific and to separate measures to increase housing stock from measures which increase access to adequate housing at a reasonable proportion of income.

The advantages of this alternative are that it would:

(i) Terminate a program which has the potential for significant abuses in terms of the client group served and delivery inefficiencies;

(ii) Terminate a program in which the federal government undertakes only long term subsidy commitments without proper assurance they will go initially and throughout the commitment period to the appropriate target group;

(iii) Allow the Corporation to devote more real resources to assisting persons who are in real need; and

(iv) Allow a direct subsidy program to the client which is more appropriate than a construction program.

The disadvantage of termination of these programs is that it would:

(i) Cause a 'sunk' loss of federal funds which have already been expended for the development of non-profit and co-operative projects which have not yet been approved for federal funding.

Rehabilitation

The principle of assistance for rehabilitation was endorsed but it was thought that the program could be restructured to be more cost effective and to channel assistance more directly to those in need of aid. Consequently, it was felt that the program should be reviewed with a view to specifying financial requirements for owner-occupants on the basis of net wealth as well as income. In the interim, assistance to landlords for rental accommodation could be withdrawn. The rehabilitation component of Rural and Native Housing should not be considered part of these options.

The advantages of the Task Force objectives are that:

(i) The program will be targeted to needy groups and delivered in a very direct way;

(ii) The possibility of benefits going to those not truly in need will be reduced; and

(iii) Unnecessary federal assistance to landlords will be reduced.

Although there would be less rehabilitation carried out, it is questionable whether low income households would be greatly affected by this withdrawal.

Income Maintenance or Shelter Allowance

After considering the general housing supply situation expected in the 1980's, the needs of low income Canadians, and the problems identified with the above programs, the Task Force briefly considered the replacement of most existing social and departmental housing programs with direct grants to individuals. These grants could be conditional on the attainment of adequate accommodation at an appropriate proportion of income or they could be general income transfers.

Direct grants have the advantage of delivering housing assistance to the appropriate target group with minimum distortion to the housing market and with maximum efficiency.

A full analysis of such schemes was outside the purview of this Task Force. The scope and cost of such schemes were not investigated; similarly, the Task Force did not attempt to measure the impact on the market of such demand, in particular, whether a high enough level of demand would be created to stimulate an adequate level of construction and rehabilitation of the existing housing stock.

Community Services Grant Program

The Task Force considered termination of the program at the end of the current federal-provincial agreements but leaving the legislative authority intact so that where a specific need can be demonstrated, CMHC could act.

The advantages to terminating the program are:

(i) The withdrawal of a federal program which is essentially addressed as a municipal problem;

(ii) The removal of responsibility from CMHC for a fiscal transfer program that is only very indirectly related to housing; and

(iii) The freeing of resources to meet specific housing needs identified.

One conceivable disadvantage to the termination of federal funding for the program on an on-going basis is that the federal government will decrease its power, however vague, to improve community environments for Canadians.

6.4 Personnel Adjustment Program

The Corporation contains a pool of highly skilled personnel consisting of housing appraisers, inspectors, program administrators, and financial and policy analysts. These individuals would make a valuable contribution to many places of work in Canada as their particular expertise is unique and much sought after by other governments and private enterprises.

There was serious concern that any re-organization of the Corporation, resulting from this report, be implemented in such a way so as to avoid interrupting the career pattern of any employee. Therefore, ways to ease and smooth any transition for the employees were considered. The main objective to be addressed is to

make contact between CMHC staff and potential new employers and to make each party fully aware of their potentials and capabilities. The fact that CMHC personnel are not considered part of the federal civil service for employment purposes was considered a definite limitation in finding alternative employment for CMHC staff.

One possible way is to employ a consultant, experienced in the field of employee relocation, who is capable of providing a comprehensive conselling service and who has offices and qualified staff in all major centres in Canada. This consultant could have the authority to draw upon the resources of the Public Service Commission and to implement a comprehensive program that could entail the following components:

(i) Consultation with CMHC regarding the how, when, and where of terminating the employees. This includes recommendations regarding severance pay, and discussions about the tax and legal implications of terminating an employee;

(ii) Counselling with the employees to help them in dealing with the emotional impact of being terminated;

(iii) Financial counselling to evaluate the economic impact upon the individual, and to plan the individual's finances while between jobs. This includes personal cash flow projections, investment recommendations, and financing requirements;

(iv) Career planning and goal-setting with a consultant representative. This may also involve a psychological assessment of the person's strengths and weaknesses, interests, and motivation;

(v) Preparation of the self-marketing plan, including resumes, broadcast letters, prospect lists, and mailing lists;

(vi) Development of a strategy for approaching job prospects, including advertisements, personal contacts, recruiting consultants, and the 'hidden job market';

(vii) Interview training, including role playing, feedback, and preparation of responses to standard questions;

(viii) Ongoing direction and advice during the job search;

(ix) Evaluation of alternative positions as they become available.

6.5 Recapitulation

CMHC has carried out the dual functions of financial intermediary and social policy agency. The mixing of financial and social policy functions has meant that the costs of each operation are unclear and the objectives of each become distorted so that neither function is implemented in its most efficient way. The private sector holds financial expertise and operating experience. The government's primary function in housing should be to implement the social policies appropriate to the day.

A decreased need for direct federal activity in housing and mortgage markets is warranted.

CMHC activities in mortgage insurance could be discontinued with little effect on public policy and with substantial operating savings and reduced contingent liabilities for the federal government.

The forecast operating deficit on the mortgage portfolio administration can be reduced by transferring management and/or ownership to the private sector.

Corporate revenues could be increased by the sale of the real estate obtained by foreclosure and presently under CMHC management, and the $20 million

appropriation and $30 million cash claim on the MIF could be accordingly be reduced.

The subsidy functions could be realigned in such a way that the federal and provincial roles are disentangled and programs more effectively directed to specific groups in need of housing assistance.

The federal role in housing would then evolve to be:

(i) A continuing concern with the supply of mortgage funds through federal re-insurance of all mortgages;

(ii) A continuing concern with the distribution of and access to mortgage funds to be implemented through the activity of lender of last resort at appropriate charges, for those individuals not serviced by the private sector; and

(iii) A continuing concern with access to good quality, affordable housing for those households who are not able to obtain adequate accommodation on the private market at a reasonable proportion of their incomes, through the use of rent subsidies, rehabilitation grants to owner-occupants, grants and loans for rural and native persons, or through income maintenance or direct cash transfer programs, and through research and demonstration projects.

7 RECOMMENDATIONS

The first section of this Chapter presents the recommendations of the Advisory Committee; the second section describes the financial implications on the federal government of the recommended changes; and the third section discusses federal-provincial concerns to be addressed if the recommendations were to be implemented.

7.1 Recommendations to the Federal Government

After careful consideration of all of the advice that has been received to date, the Advisory Committee recommends that CMHC activities be primarily in the area of social or departmental housing policy and that it essentially discontinue its financial functions. The specific recommendations to effect this are set out below.

1. That CMHC be maintained in place with its current legislative authority.

2. That CMHC focus on identifying those areas where federal government involvement is required to provide adequate shelter for low income Canadians. The primary function of CMHC is to conduct federal government social or departmental housing policy.

   In this connection, that the Minister Responsible for CMHC (hereinafter 'the Minister') and the Minister of State for Social Policy direct a study on the feasibility and financial cost of replacing most existing social and departmental programs with a direct income maintenance or direct housing allowance scheme and report back to Cabinet by the end of 1980.

3. That the following CMHC departmental functions be given special consideration, as described:

a. <u>Public Housing</u> (50 year subsidy commitments)

That the government commence negotiations with the provinces with a view to eliminating subsidies by January 1, 1982. The settlement of long-term commitments in this connection might include forgiveness of mortgage commitments on, or divestment of federal equity in, public housing. No new capital projects should be considered at this time, nor any new long-term subsidy commitments on provincially owned housing.

b. <u>Community Services</u>

That the Government of Canada notify the provinces that the program will terminate as of December 31, 1980 when the current federal-provincial agreements expire. That federal contributions be made on eligible and approved projects until March 31, 1982.

c. <u>Residential Rehabilitation</u>

That no further funding be considered for landlords until this section has been carefully reviewed. That CMHC carefully review the loan and grant program with respect to owner-occupants with a view to:

i. securing the funding from private sources, and

ii. making grants only after net assets as well as income have been considered.

d. <u>Non-Profit and Co-operatives</u>

That funding be withdrawn from both the public and private non-profit and co-operative programs with the thought of developing a more efficient delivery system of benefits for low income households, but that the implied subsidy

commitments contained in fully committed development funds be honoured.

e. That all operating costs related to CMHC social programs be recovered from the Minister through appropriations.

4. That CMHC cease writing mortgage loan insurance, except in extreme circumstances when the private market cannot supply this service in remote areas. CMHC would stop underwriting insurance at a time designated by the Minister once a decision has been made about the best mechanism to be used to remove mortgage insurance activities from CMHC. That the Minister employ consultants to advise him on the mechanism to be used. While there are two general routes that can be considered -- one involves the sale of assets and liabilities on an on-going basis, and the other involves the management of the liabilities of the mortgage insurance portfolio and of the assets of the Mortgage Insurance Fund -- we recommend sale of the assets and liabilities. That the Minister report back to Cabinet on the preferred mechanism by the end of February, 1980.

5. That the Minister of Finance be asked to amend the Bank Act to allow banks more flexibility in the ratio of Canadian mortgage loans to Canadian dollar deposits.

6. That the government provide re-insurance for the mortgage industry. Such re-insurance would be short of a government guarantee but would raise the security provided by private mortgage insurance to a level that is somewhere between that provided currently by private mortgage insurance and by National Housing Act mortgage insurance. It could also be used to serve other housing needs.

7. That the Minister appoint an individual to immediately assume responsibility for the management and sale of all the properties currently held by the Corporation through foreclosure in connection with direct lending or the mortgage

insurance program. The individual should be free to take such actions as are required to maximize the return on the assets involved. It is equally important that this individual be instructed to deal in the most sensitive manner possible with the very urgent personal problems that confront many individuals who have been encouraged into buying housing which is now beyond their means.

8. That the Minister appoint an individual to:

   a. arrange for the management of the mortgage portfolio to be contracted out, and

   b. assemble the information required to sell the portfolio and then on the instruction of the Minister, to liquidate the portfolio. (If any portion of the portfolio is to be sold, it should be offered to those who are on the mortgage at the same discounted price, before any bulk transfer.)

9. That those employees who are displaced by the re-organization of CMHC be treated as though they were civil servants, be allowed to compete for positions in the public service for a two-year period, and be placed on an initial 6 month priority list. The Minister should appoint an individual to implement a personnel adjustment program which involves careful management and attention to each individual so that employees of the Corporation will undergo no interruption in their career patterns. The individual would have the authority to call on the resources of the Public Service Commission and the program would encompass the components listed in section 6.4 of the previous Chapter.

7.2 Financial Implications

1. Insurance Function

Method One - Creation of a New Company

The Superintendent of Insurance estimates that a capital investment of $25 million would have to be made into the new company to enable it to meet the regulations of the Insurance Act dealing with the ratio of equity to liability.

The Consolidated Revenue Fund (CRF) would be freed of the responsibility for funding the illiquid Mortgage Insurance Fund after the new company had been sold. It is estimated that loans required from the CRF in 1980 will amount to $140 million, unless there is a substantial acceleration of real estate sales.

CMHC would be freed of the loss incurred in the initiation of mortgage insurance. This would result in a saving to the Corporation of $15 million a year.

The Government would no longer incur large volumes of additional liabilities and foreclosed real estate.

Method Two - Contracting out Management

This proposal requires no capital investment and allows the CRF to take the residual of the Mortgage Insurance Fund as and when liabilities have been discharged. The CRF would be required to finance the loans for the Mortgage Insurance Fund. With careful and prudent management of the mortgage insurance portfolio, one would expect to minimize the losses associated with foreclosure and very much reduce the turn around time betweeen foreclosure and resale and thereby substantially reduce the cash demands on the CRF.

The Corporation would be freed of the loss incurred in the initiation of mortgage insurance. This would result in a saving to the Corporation of $15 million per year.

The Government would stop incurring additional liabilities.

2. <u>Introduction of a Re-insurance Program</u>

This program would be financed out of the fees as established by the Superintendant of Insurance.

The exposure of the government would be considerably less than under the existing arrangements of NHA insurance.

3. <u>Real Estate Portfolio</u>

The Corporation has almost $500 million invested in real estate that would be sold over the next five years. This will result in a net inflow of $500 million into the CRF and the MIF less the cost of operation and sale, plus rental income before sale, and plus or minus the difference between current valuation and sale price. By careful management of each individual structure and the adjustment of rents to market prices, we would expect to maximize the return by putting full occupancy buildings on the market.

4. <u>Savings for Subsidy Functions</u>

Table 7.2.1 sets out the expenditures which would not be made and therefore the cash which would not have to be drawn from the CRF, if the recommendations were implemented and if the negotiations with the provinces on the long-term public housing subsidies were successful. They do not include consideration of the cost to the government of settling the loans and equity for public housing. The figures should not be considered as net savings to the government. Rather, these expenditures reflect the general magnitude of a direct grant

Table 7.2.1

Reductions in Non-Budgetary and Budgetary Advances if Recommendations Implemented

$ millions

Non-Budgetary Cash Advances	80/81	81/82	Year 82/83	83/84	84/85
Public Housing - No new capital commitments after 1979.					
S. 40 (reg.)	21.1	37.0	36.8	39.8	43.1
Rehabilitation - No new commitments after 1979. for rental and non-profit	3.2	4.3	4.8	5.0	5.2
Sub-Total	24.3	41.3	41.6	44.8	48.3
Budgetary Cash Advances					
Public Housing - No new subsidy commitments on new construction after 1979.					
S. 40 (reg.)	-	0.5	3.1	7.5	12.0
S. 44 (prov. owned units)	-	0.9	4.8	11.0	17.9
Public Housing - Existing stock: expenditures not made if provinces agree to terminate federal subsidies, Jan. 1, 1982.					
S. 40	-	-	59.1	69.0	72.8
S. 44	-	-	187.4	219.4	232.4
Non-Profit and Co-operative - No new subsidy commitments after 1979 except for units implied in fully committed development funds.	1.0	13.6	37.5	70.2	108.4
Rehabilitation - No new subsidy commitments after 1979. for rental and non-profit	17.3	26.1	30.8	30.8	30.8
Community Services - Termination after 1980.			250.6	250.6	250.6
Sub-Total	18.3	41.1	573.9	658.1	724.7
Total	42.6	82.4	614.9	703.3	773.2

program which could be considered to replace the current social housing programs.

The figures are based on the CMHC 1979 approved 'A' base budget.

7.3 Federal-Provincial Considerations

1. The privatization of the insurance function is expected to be viewed favourably by all but some provinces and territories which have large rural populations which might not be well serviced by the private sector. The re-insurance provisions or other special provisions should assist these populations. These provinces are also expected to seek a continuation of CMHC mortgage lending functions, on a last resort basis, for rural areas.

2. The provinces may react negatively to a large amount of real estate being sold on the market at one time. Tenants facing rent increases could approach the provincial government for a rent supplement. When this occurred in one province last year, that province was not happy about tenant pressure to increase the government's subsidy budget by a large amount over a short period of time.

3. All provinces are currently operating their own housing programs to meet the housing needs which they perceive to be priorities. Without exception, provinces consider that programs designed by the federal government to apply equally to all provinces are not the best way to meet the housing needs perceived as priorities by their governments. Provincial governments seek maximum flexibility in applying federal funds to provincially perceived housing needs. Provinces consider federal-provincial administration of housing programs a duplication and overlap of federal and provincial government services. The Premiers called for a reduction of this at their 1978 conference in Regina.

Federal and provincial agency negotiation on this have not progressed very far, however, because the provinces appear to prefer duplication to an elimination of federal funds. For this reason, provinces can be expected to press for continuation of the Rehabilitation and Community Services Contribution programs. The phasing out of the Rehabilitation program might be a minimal acceptable position to them. They might attempt to have the Community Services funds replaced through increases to other programs such as the Established Program Financing.

4. Provinces are particularly concerned with the rising cost of public housing subsidies and are seeking alternative ways to control expenditures. Most provinces would react strongly to suggestions by the federal government to limit federal expenditures on public housing units currently under long term contract for cost-sharing. One province has suggested a settlement of the public housing debt and the federal expenditures committed in subsidy contracts. The reaction of other provinces to this suggestion has not been enthusiastic. Provincial interest in seeking new arrangements for existing commitments might be dependent upon a new federal program which relieves provinces of their subsidy costs.

APPENDIX

Criteria for Privatization

The following is a description of the criteria used in the analysis of the options for privatizing CMHC activities.

(i) Resource Allocation

Resource allocation refers to the distribution and allocation of scarce financial and real resources throughout the economy. A major objective of privatization is to minimize distortions in the allocation of financial and real resources throughout the economy and to facilitate the flow of resources to the appropriate activities. In a perfectly functioning economy these resources will be allocated to their appropriate sectors according to the relative strength of demand for various goods and services and their relative costs of production.

If market imperfections exist which impede the free flow of resources and funds, if a monopoly exists which distorts the allocation of resources, or if activities have social benefits or costs which are not reflected in the price and hence in the allocation of resources, government activity is justified to compensate for the imperfections, to offset monopoly distortions, or to reflect the differing social and private benefits. However, if such market distortions or impediments do not exist there is not a justification for government intervention on resource allocation grounds, and such intervention is likely to be counter-productive by introducing other distortions in the allocation of resources.

(ii) Cost Effectiveness

Cost effectiveness refers to the most efficient and least costly method of delivering an output to final consumers. If output could be produced at a lower cost by the private sector and be profitable, this criterion

would also suggest that activities be shifted from the federal government to other levels of government (or from CMHC to other government departments or agencies), if (a) the activities were deemed on this or other grounds to be appropriate for government; and (b) other levels of government or other departments or agencies could perform the functions at a lower overall cost. The implication of such cost effectiveness is that activities will be conducted most efficiently, freeing economic resources for other uses, or providing more output for the same cost.

(iii) Cyclical Stability

Cyclical instability refers to the fluctuations that occur periodically in the housing sector and in the economy at large (e.g., GNP, rate of inflation, unemployment, etc.) If a CMHC activity or policy substantially reduces such fluctuations in either the housing sector or the overall economy, its continuation could be justified on this ground. Significant in applying this criterion, is our concern with massive fluctuations, as opposed to minor fluctuations, since this criterion is directed towards avoiding large distortions that major instability might generate, such as the booms and busts that have typified certain sectors of the Canadian economy (e.g., mining and construction). In applying this criterion, account should also be taken of the tendency for residential construction to fluctuate in an anti-cyclical manner so that mitigating fluctuations in housing might accentuate overall instability (i.e., if housing booms correspond to general business down turns, taking the edge off such booms might affect the ability of the economy to turn up). However, if protecting housing from bearing a disproportionate impact from general stabilization policies is appropriate, then sheltering housing from disproportionately large fluctuations might enable the general stabilization policy to be pursued more vigorously and impact more uniformly throughout the economy. Consequently, if an activity has the potential to mitigate major fluctuations in the housing sector or general economy, its retention by the government may be appropriate.

(iv) Social Policy

Social policy refers to policies pursued by governments to enable Canadian residents to have access to a socially acceptable minimum standard of living. This includes access to a socially acceptable minimum of housing services, nutrition, medical care, and other necessities. Such policy can be conducted by direct income subsidies, by conditional subsidies such as a shelter allowance, or by in-kind transfers of commodities. If a government housing activity performs such a socially desired role its retention should be considered according to this criterion. However, the applicatin of this criterion should also consider the relative appropriateness and effectiveness of different policies directed toward delivering the socially desired income distribution. The major factors to be considered in determining the appropriateness of shelter policies should normally be the equity with which the policy treats clients with the same needs who must purchase accommodation in the different housing markets and the cost effectiveness of delivering such transfers.

(v) Canadian Control

Canadian control of real resources refers to the retention of ownership by Canadian residents of housing and the control of housing related business, but not necessarily to the retention of financial assets such as mortgages or other portfolio items by Canadian residents. If the privatization of an activity were to result in the ownership or control of major housing or housing related activities passing from Canadians to non-Canadians, privatization would conflict with this criterion. If, on the other hand, the privatization of an activity were to result in the ownership of mortgages or other financial assets passing to non-Canadians, privatization would not conflict with this criterion since this would be a portfolio transaction and not in the normal course involve ownership or control of real resources or activities.

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